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DEPARTMENT OF BUSINESS ADMINISTRATION

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THE JOURNAL OF Taxation

A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

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MAY 1957 • VOL. 6 • NO. 5

THE JOURNAL OF *Taxation*

THE JOURNAL OF TAXATION is published monthly by The Journal of Taxation, Inc. Publication office, 320 North Sixth Street, Paterson 2, New Jersey; editorial office, 147 East 50th Street, New York 22. Telephone PLaza 3-8258. Material for publication is welcomed, either technical manuscripts or news items of interest to professional tax men. While the utmost care will be given material submitted, we cannot accept responsibility for unsolicited manuscripts.
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Application pending for re-entry at Paterson, N. J., March 13, 1956.

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TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

Current status of Sec. 355 as a means of getting tax-free divisions of corporations

by LESTER M. PONDER

Because the new Section 355 was something of a liberalization of the old rules, it is hedged about with limitations on use of its provisions. One difficulty is failure of the Code to define terms. In this estimate of how and when to use Section 355, Mr. Ponder points out areas where litigation is likely to arise, areas where the Commissioner is being more rigid than the law seems to require, and deals extensively with the all-important "business purpose test."

IN ENACTING the 1954 Code, Congress was acutely aware that many difficulties in making tax-free separations of a corporate business into several component parts had arisen under the 1939 Code. When the 1954 Code was under consideration, it was explained to the Congress that many valid reasons existed for the separation of corporations into two or more entities. It was also pointed out that regardless of the method chosen to accomplish this result, it was virtually impossible to achieve this goal without the payment of at least a capital gain tax.

Accordingly Congress enacted Section 355 of the 1954 Code to make tax-free valid separations of a corporation into two or more entities. The strict requirements of Section 355 show that Congress did not intend to allow the conversion of what would otherwise be ordinary income into capital gain.

Basic requirements

There are certain basic requirements for a tax-free separation under Section 355. There must be a parent corporation, which is referred to as the "distributing corporation," and a subsidiary corporation, which is at least 80% controlled by the parent, at least at the moment prior to distribution. The subsidiary is described as the "controlled corporation." If this corporate framework is present (assuming the other qualifying requirements are also met), the parent is permitted to divest itself of its subsidiary simply by transferring the stock of the subsidiary to its shareholders or securityholders. Under such circumstances, it is provided that if an exchange occurs as part of the "Section 355 transaction" that "no gain or loss shall be recognized." If the Section 355 transaction is achieved without any surrender of stock by the recipient shareholder so that there is no exchange, then "no amount shall be includible in the income of" the shareholder.

Since Subchapter C fails to include definitions of the term "stock" and "securities," the general meaning of these terms already established by the courts under the 1939 Code would seem to apply. Hence, the principle enunciated in *Pinellas Ice and Cold Storage Company* and similar decisions will probably prevent the use of short-term obligations or other instruments which are not securities regardless of whether an exchange has occurred.

The 1954 Code does not however, describe the nature of the "stock" which may be distributed, with or without an exchange. The use of the general term "stock" would seem to imply that preferred stock, as well as common, could be distributed tax-free under Section 355. Although this provision might seem highly advantageous at first glance, it should be noted that preferred stock received under Section 355 would be "Section 306 stock," at least to the extent preferred stock, which is not "Section 306 stock," is not surrendered in the transaction.

The question of whether the instrument received is a stock or security is significant because under Section 356 securities received are taxed, except to the extent that equivalent face amount of securities may have been surrendered by the recipient in the same transaction.

As previously pointed out, one of the most drastic changes in this field of corporate separations is that shareholders of the parent corporation are not required to surrender stock in order to qualify for the tax-free result. It is true that this result was permitted for spinoffs under Section 112 (b)(11) of the 1939 Code during its relatively brief life. Even so, many tax advisors preferred to use the splitoff method, and it was thought to require an actual exchange. Section 355 eliminates the difficult question of which technique to use.

Business purpose test

One of the safeguards built into Section 355 to prevent its misuse is the business-purpose test. In order to qualify under Section 355, a transaction must not be principally a distribution of the earnings and profits of the distributing corporation, the controlled corporation, or both. Similar language was contained in the 1939 Code with respect to spinoffs, but not for splitoffs and splitups. The last two methods were governed on this point by the body of judicial authority which had its origin in the *Gregory* case. The significance of the business-purpose test is apparent if the recipients of the stock of the subsidiary corporation desire to sell it within a reasonably short period after its receipt. Section 355 does provide that the mere fact of subsequent sale "shall not be construed to mean that the transaction was used principally as" a device to distribute earnings. Seasoned tax counsel will read between the lines and note an ominous implication.

Those who have sought Rulings in this area under the 1939 Code will recall distinctly the requirement of the administrative officers that recipients agree that at the time of receipt of the stock

there was no present intention of disposing of it. It is clear that if a later sale is made pursuant to an arrangement "negotiated or agreed upon" before receipt of the stock or securities, the Commissioner will argue that Section 355 did not apply. The Regulations construe this provision as meaning that a sale will not be considered "agreed upon" prior to the distribution unless enforceable rights to buy or sell then existed. It is probable that considerable controversy will arise in connection with sales after such stock distributions. Only after judicial interpretation of the business-purpose concept in this specific field of corporate separations will the tax practitioner be able to mark off the limits beyond which his client should not go in making sales of stock or securities received as a tax distribution or exchange under Section 355.

Stock to be distributed

Another stringent provision for qualification under Section 355 is that *all* (or, under specific conditions noted below, the control) of the stock and securities in the controlled corporation held by the distributing corporation immediately before the distribution must be distributed as part of the transaction. For example, if a wholly owned subsidiary is to be spun off, all of its stock must be distributed to the recipient receiving tax-free treatment. This rule does not require that the parent own all of the outstanding stock or securities prior to the distribution; it applies only to such stock or securities as are actually owned by the parent at the time. If the parent does not distribute all of the stock or securities, nonrecognition of gain is possible under specific statutory conditions. First, there must be distributed enough stock of the subsidiary to constitute control. Second, the retention of stock or securities by the parent must not be in pursuance of a plan having as one of its principal purposes the avoidance of income tax.

Pro rata distribution not required

One of the major benefits of Section 355 is that it can be used to satisfy demands of a dissident minority of shareholders who want separation of an existing corporation into two or more entities. Frequently, differences of opinion or family frictions result in such a deadlock that the only solution is separation. If the corporation can be split to meet the active-business test, Section 355 may be an excellent solution. The effect of Section 355 is to allow the distribution of one of the businesses of a corporation to one group of shareholders and of the other business of such corporation to a different group of shareholders without recognition of gain to either. Pro rata distribution is no longer required.

The strict requirements of Section 355 and of Subchapter C in general must be met. But for taxpayers who control a corporation which is conducting two or more separate businesses, this may not be too difficult.

Another great benefit of Section 355 as compared to prior law is that a reorganization is no longer required.

The active-business rule

Under Section 355(b), the corporations involved must be engaged in "the active conduct of a trade or business" as a primary condition to a tax-free corporate separation. The nature of the activities which will qualify under this provision will be spelled out over many years in Rulings and judicial decisions. The examples contained in the Regulations explain the initial interpretation by the Commissioner of the meaning of this clause.

As to engaging in active business, the statute provides that immediately after the Section 355 distribution:

1. the distributing corporation must be so engaged;

2. the controlled corporation must be so engaged; and

3. if stock of more than one controlled corporation is distributed, each of such controlled corporations must be so engaged, unless the distributing corporation has "no assets" other than stock of controlled corporations, in which case the requirement is applied only to the controlled corporations.

In spite of the crucial importance of the active-business requirement in Section 355, the statute itself furnishes no real assistance in interpretitng its meaning. Further, the 1954 Code does not indicate what, if any, business changes can be made without destroying the five-year continuity requirement. The probable reason for this ambiguity in the statute is that Congress was keenly aware of the difficulty of reducing to a specific formula a concept which must cover widely varied factual patterns.

Certain extreme limits may be recognized. For example, a corporation engaged in the mere holding of securities would not qualify as engaged in the active conduct of a trade or business under Section 355. On the other hand, a branch engaged solely in selling goods to outsiders would seem to be so engaged. Only time and experience will tell where between these extremes the line will be drawn. The Regulations under Section 355 summarize the general criteria utilized by the Treasury:

". . . a trade or business consists of a specified existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

"1. The holding for investment purposes only of stock, securities, land or other property, including casual sales thereof (whether or not the proceeds of such sales are reinvested),

"2. The ownership and operation of land or buildings all, or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

"3. A group of activities which, while a part of a business operated for profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial."

New definition is narrower

A careful reading of the Regulations seems to indicate that the Commissioner's definition of an active business is narrower than under prior law. For example, spinning off a building in which a business was conducted as the chief asset of a subsidiary corporation is in his view of the meaning of Section 355 no longer permitted. He would distinguish between a building entirely occupied by the parent and one which the owner used only a small part of and rented the remainder to outsiders. Only the latter situation would qualify under

[*Mr. Ponder is a tax attorney, partner in the Indianapolis law firm of Barnes, Hickam, Pantzer & Boyd. He is a frequent contributor to these pages. This article is based on a paper written for the last Marquette University Tax Institute*]

Section 355. Considerable litigation in this area is likely.

The five-year rule

In addition to all its other conditions, Section 355 requires that the active business must have been actively conducted for a period of five years ending on the date of the distribution. Such activity may have been by the distributing corporation. However, if the business itself had been acquired by the distributing corporation within the five-year period in a tax-free exchange, then the conduct by the transferor during the five-year period may be included to meet the test. This five-year provision is going to reduce the number of corporations which can use Section 355. Undoubtedly, Congress felt that only corporations which had a considerable history of business existence should be afforded the advantages which are inherent in this section. ☆

ABA discloses new Service Rulings restricting liquidations, redemptions

MANY TAX MEN have had the frustrating experience of having the Service flatly decline to issue a Ruling. This stone wall may be breached only after a great amount of effort and expense have gone into the preparation of a Ruling application and for the essential study and research. As a service to tax men and their clients, the American Bar Association Taxation Section noted in the January 1957 *Bulletin* of the Section these significant areas of Subchapter C where the Service has indicated it either will not issue Rulings or will rule adversely.

We will quote liberally from the Publications Committee material with the hope that tax men may be saved from the frustration of a "no Ruling" response or perhaps an unfavorable Ruling from the Service. (It should be noted that any nonquoted comments reflect the views of the *Journal*, rather than the ABA).

Complete-termination redemptions

The first and important policy revelation relates to a complete-termination redemption under Section 302(b)(3), where a spouse continues on in the business as a stockholder. The Taxation Section Publication Committee makes the important disclosure of the current Service's negative policy on this point:

"Section 302(c)(2) provides that the attribution rules shall not apply to redemptions which constitute a complete termination of interest if, generally speaking, the distributee has no further interest in the corporation even as employee for the next ten years and if the distributee did not acquire his stock within the preceding ten years from a related person. Thus the redemption of all of the stock of a stockholder would be treated as a capital gain transaction under these statutory rules even though his wife, children, grandchildren, or parents continued to own stock in the corporation if the so-called 'ten-year look-back' and 'ten-year look-ahead' requirements are met. The Service will issue Rulings applying these statutory provisions to contemplated redemptions in family ownership situations *except* where the redemption is from a husband or wife and the other spouse still retains stock."

Apparently the Service is contemplating adhering to the common-law concept that the "husband and wife are one, and the husband is the one." This is in marked contrast to the recent favorable Ruling where a father was permitted the benefits of the complete-termination rule of Section 302(b)(3) although a son remained in the business and had received his stock by gift during the "ten-year freeze-back" period (*Rev. Rul.* 56-556 discussed in 6JTAX 12).

Partial liquidations

The Taxation Section also reveals a major restriction on the issuance of Rulings on partial liquidations under Section 346 involving a distribution in kind. The effect of this policy seems to be that no Ruling will be issued under the general rule of Section 346(a) where the distribution involves a property distribution, although a Ruling may be forthcoming if the taxpayer qualifies for a termination of a business under Section 346(b). This restriction is explained this way:

"The Service has indicated that it will not rule on the question whether a distribution is in partial liquidation under Section 346(a) if it is a distribution of assets in kind, as distinguished from a distribution of cash proceeds from the sale of assets. Section 346(a) is the general rule providing for treatment of a distribution in redemption of part of the corporation's stock as a partial liquidation where it is not essentially equivalent to a dividend, and it is intended to apply, inter alia, to a genuine contraction of the business. Sen. Rep. 1622, 83d Cong. 2d Sess. 262. The Service, however, has indicated that it will rule under Section 346(b) on a transaction involving a distribution in kind. Section 346(b) is the specific rule providing for treatment of a distribution as a partial liquidation upon the termination of a trade or business. In no case, however, will the Service rule on the factual question as to whether the sale of assets was made by the corporation or the stockholders."

Dividend equivalency tests

There are numerous occasions when the mathematical tests of achieving capital gain in stock redemptions (i.e., complete terminations and disproportionate redemptions) cannot be relied upon. In this situation, the taxpayer may wish to seek refuge in the general rule of "not equivalent to a dividend" under Section 302(b)(1). The Congressional intent, as evidenced in the Committee Reports, was to adopt the judicial standards and principles of the old Section 115(g)(1) in administering Section 302(b)(1), and there was no authority for using the attribution rules under Section 115(g)(1).

Nevertheless, and over the objections of various Bar Associations, the final Regulations under Section 302 did provide for tacking the attribution rules onto the general rule of dividend equivalency under Section 302(b)(1) (See 4 JTAX 269). In the typical family-corporation-redemption case, this often means that if the complete termination or disproportionate-redemption rules of Section 302(b)(2) and (3) cannot be met because of the stock-attribution rules, the same stock attribution may well prevent capital gain treatment under the dividend-equivalency test of Section 302(b)(1).

Explanation of policy

The ABA Taxation Section Subcommittee explains this Internal Revenue Service policy.

"There is some question whether the attribution rules of Section 318 were

ever intended to be effective in the application of the general provision in Section 302 (b)(1) that a stock redemption which is not essentially equivalent to a dividend shall be treated as a sale or exchange. The Regulations provide for such application. This may be erroneous for if there is any purpose in providing capital gain treatment under such a broad general test independent of the specific tests provided in Sections 302(b)(2), 302(b)(3), and 302(b)(4), whether the redemption is essentially equivalent to a dividend should not be predetermined by the application of narrow constricting rules. Regardless of the attribution rules, special circumstances may render a redemption as not being essentially equivalent to a dividend. Rev. Rul. 55-515, 1955-2 C.B. 222; Rev. Rul. 56-103, 1956-1 C.B. 159. In any event, the Service will not rule favorably under Section 302(b)(1) where the redemption is considered essentially equivalent to a dividend after application of the attribution rules if one of the other redemption tests is not met."

As previously noted in this department it is possible to eliminate the tax at the corporate level in a condemnation case by means of a Section 337 liquidation. The timing of the adoption of the plan of liquidation becomes vital, as suggested by the Taxation Section.

Government condemnation

"The Service will soon publish a Ruling holding that Government condemnation of the corporation's sole asset does constitute a sale of that asset for purposes of a Section 337 liquidation. However, the Service has also held that the date of sale is the date of the condemnation decree, rather than the date compensation is finally determined. Thus, in order to qualify for a Section 337 liquidation, the corporation's shareholders must adopt a plan of liquidation prior to the condemnation decree, and the corporation must distribute its assets within the following twelve months (if need be, by assignment to shareholders of its rights to compensation under the condemnation decree)."☆

Treasury reduces personal-service threat; only fee for stockholder is PHC income

In April this department warned that the Treasury Department was proposing a new definition of personal holding company income under which most personal-service corporations would become personal holding companies and subject to the punitive personal holding company tax. While there was a lot of protest from Hollywood, the Treasury's acknowledged target, other tax men were concerned because the rule would apply to millions of small corporations rendering service actually performed in part by their stockholders.

In the face of this storm, the Treasury changed its proposed Regulation. It now proposes that only the portion of the payment attributable to the service of the stockholder be treated as personal holding company income.

TIR 44

The new Treasury stand is set out in TIR-44, which says: "The Regulations relating to personal holding companies when adopted as a Treasury Decision will contain a modification of a rule contained in the proposed Regulations relating to amounts received under certain personal-service contracts. . . .

"Under the rules to be prescribed, in any case where the contract requires the corporation to furnish other important and essential services, only that portion of the amounts received under the contract attributable to the personal services of such stockholder will be treated as personal holding company income."

Change was headlined

This change was headlined by *The New York Times* as a compromise. The rule in the Regulations under the 1939 Code was that amounts received under a contract would be personal holding company income only if personal services were performed by one individual owing at least 25% of the stock. Under the new version of the proposed Regulation, a corporation will not be free of personal holding income, as it was under the old Regulations, when services of more than the stockholder are required. Part of the fee (that allocable to the services of the stockholder) will be personal holding company income.

Actors have been historically sensitive to this confiscatory tax. The corporations formed by some of the early stars probably stimulated the need for the first personal holding company surtax and resulted in making certain personal-service contract income subject to the tax under Section 543(a)(5). Thereafter the tax planners figured that the stars could safely organize producing companies to provide a complete and packaged show. This arrangement differed from the early simple deal: the sponsor or broadcasting company was furnished an "integrated entertainment package," consisting not only of the star's services but also of supporting actors, writers, directors, and others. Since more than 20% of the gross income of the corporation was attributable to the supporting cast, it was thought that the corporation did not meet the income test for a personal holding company. Under this view, 80% of its income was not personal holding income under a contract for services performed by one individual owning 25% of the stock.

The original proposed Regulation (Section 1.543-1(b)(8)) would have rendered the entire income from such a package contract subject to personal holding company tax. It said: "the fact that the contract, in addition to requiring the performance of services by a 25% stockholder . . . requires the performance of important and essential services by other persons is immaterial and *all* amounts received under such contracts constitute personal holding company income." To make the point doubly clear to all concerned, there was included a pointed example where the essential services of a good supporting cast were held to be immaterial to prevent the entire amount of $500,000 received under the contract from constituting personal holding company income.

Personal-service firms still vulnerable

Of course, this change of position by the Treasury still leaves personal-service companies in a vulnerable position if they contract for services of their stockholders and if 80% of their income is personal holding company income and they do not distribute all their earnings. It may be that not many personal-service companies are so simply operated that 80% of the fees are attributable to services of a stockholder owning 25% or more of the stock. We may have here a new tax trap. A corporation ordinarily safe in years of normal operation may

in one year of low income find itself a personal holding company. The personal-service corporation may be joining the family-investment company as a favorite victim of the personal holding company tax.

How PHC affects investing companies

Incorporating family investments offers vigorous tax benefits, the major one being the corporate dividend-received credit. As a result of this 85% credit to a corporation on dividends received from another corporation, the effective corporate income tax on dividends will be either 4.5% or 7.8%, depending on whether the corporate net income is under or over $25,000.

Thus, Brown Investment Company pays only $450 in corporate income tax on the $10,000 of dividends. But if the Brown family had received those dividends directly, at their 75% bracket the tax would have been $7,500. Hence, the dividend income is relatively free of income tax and can be plowed back for reinvestment, subject, of course, to the Section 531 surtax on unreasonable accumulations.

These may become a problem as the earned surplus passes $60,000. A "mere" investment or holding company cannot show any accumulated earnings credit in excess of $60,000 under Section 535(c)(3). It is not entirely clear how much activity is necessary to avoid the epithet "mere" or to what extent a corporation which merely leases real property on long-term leases, but which is liable on mortgages, can accumulate income to protect against default in the event, for example, a tenant stops paying rent.

But Brown Investment Company is not in a good position if the only corporate income is from dividends. Personal holding company tax takes 75 to 85% of undistributed personal holding company income if more than 50% of the stock is owned "directly or indirectly" by four or less shareholders and the dividend income qualifies as personal holding company income. Fortunately Mr. Brown can normally eliminate this costly problem very simply by arranging the corporate investments so that gross income includes either (1) operating income equal to at least 20% of the total gross or (2) rental income equal to at least 50% of the total gross income. (Section 543).

Thus, Brown Investment Company could invest in a one-third undivided interest in an unincorporated drug store which would produce the required 20% of operating income. Easier still, it could acquire some rental property whose rents would produce the necessary 50% of gross income. If there is any problem of selling stock held by the corporation to finance the real-estate purchase and thereby producing capital gain, this problem is readily eliminated by the corporate purchase with borrowed funds. This arrangement provides the added charm of an interest deduction plus a depreciation deduction which may eliminate most, or possibly all of the taxable income, but leave plenty of after-tax dollars for reinvestment.

Over a period of time this marriage of the corporate dividend-received credit to the interest and depreciation deductions can generate substantial sums of money for the high-bracket taxpayer who incorporates his investments.

Like all tax-planning, the personal holding company tax problems should be examined frequently to make sure there has been no change of status, resulting perhaps from capital gains, drop in rentals, substantial increases in dividends, etc., any of which might reduce rentals to below the total of 50% of gross income. Special care is also required to avoid renting the property to or for the benefit of one of the shareholders of the corporation. (See Section 543(a)(6)). Subject to careful control over income, and with an eye on Section 531 et seq., this familiar device affords great advantages for the individual investor. ☆

ABA Tax Section proposes changing rules on thin-corporation ratios, debt recognition

THE ABA SECTION OF TAXATION recently recommended that the Internal Revenue Code be changed so that a corporation with a 10-to-1 debt-to-capital ratio would not be too thin. It also recommended more definite rules governing the recognition of debt owed to stockholders.

The Committee reported that it had had considerable controversy over the ratio proposal. It reported that "many members of this committee take the view that there should be no ratio limitation at all. This view is based upon the fact that since the shareholder should be allowed to elect to recover his stake in the corporation and since the courts have approved ratios in excess of 10 to 1 where the terms of the obligations reflected true debt, the objectives of the stockholders are over 90% achieved and it is pointless to make an issue of the remaining 10% (or less) segments.

"The contrary view is to the effect that it would be unwise to prevent by legislation, the courts treating debt as stock in cases of such grotesque ratios as 100 to 1 or 1000 to 1."

The Section's recommendation on debt recognition reads:

"Indebtedness of a corporation shall be deemed to include (but shall not be limited to) any unconditional obligation of the corporation to pay on demand or on a specified date a sum certain in money incurred for a full and adequate consideration in money or money's worth:

(1) When it is not subordinated by its terms to the claims of trade creditors generally:

(2) When payment, if any, for use of the principal amount is not dependent upon the earnings of the corporation, and is unconditionally payable not later than the maturity date of such principal amount; or

(3) When qualifying under some but not all of the foregoing requirements hereunder, the taxpayer claiming it to be a debt, establishes by a preponderance of the evidence that the failure of the obligation to meet one or more of the foregoing requirements was due to the corporation's business requirements.

(4) In the event the ratio of the principal amount of all creditor obligations of a corporation held in the aggregate by its stockholders exceeds by more than ten to one the book value of the stock held in the aggregate by such stockholders immediately after such creditor obligations are issued this subsection shall not apply to the amount of such creditor obligations which exceed such ratio."

The purpose of the amendment, the committee said, is to provide, through the addition to the 1954 Code of certain nonexclusive rules, an area of certainty as to the income tax treatment of debt obligations of a corporation held by such corporation's shareholders. ☆

New corporate decisions this month

Notes to owners on incorporation of partnership held really capital. [*Certiorari denied*]. The Tax Court found that no real creditor-debtor relationship was established between a corporation and a husband and wife, its chief officers and stockholders. Upon formation, the corporation had issued stock of $49,000 and notes to stockholders of about $232,000 for partnership assets worth $281,000. All other corporate debts were given preference by subordination of stockholder loans. Some of the stockholder loans were not paid at maturity. The Tax Court disallowed the interest deduction; payments to stockholders were, it held, distributions of corporate profits taxable as dividend income. The Sixth Circuit affirmed. It said the question is one of fact and that the Tax Court decision was supported by the evidence.

One dissent: everyone, including banks and other creditors, treated the notes as real indebtedness. There is no support for the Tax Court's disregard of the liability. *Gooding Amusement Co., cert. den.*, 3/11/57.

Debt recognized despite 24-to-1 ratio; notes were negotiable, had fixed due date. Nine individuals advanced $25,000 for the purchase of a tract of land. Thereafter, they organized a corporation with $10,000 of authorized capital and transferred the land to it. The corporation issued $1,000 common stock and $24,000 negotiable 10% promissory notes due in ten years. Payment of the principal could be anticipated by the corporation, provided pro rata payments were made at the same time on all notes. During its first two years the corporation paid no interest. In the fourth year the corporation was dissolved. The court allows the interest deduction in the amount of the proper accrual; the loans were debts, not contributed capital. The court stresses the fixed maturity date and the negotiability of the notes and points out that growth was possible through the sale of more stock. *Associated Investors, Inc.*, DC Kans., 12/19/56.

Promoter's guaranty of corporate loan was business. Taxpayer was in the business of organizing businesses and participating in their management. Between 1945 and 1956, he devoted his time to organizing and managing about ten companies. He was a part owner and active in the management of each business. Taxpayer personally guaranteed bank loans to a now insolvent corporation of which he was a stockholder, director, and officer. His subsequent payments on these notes are fully deductible as bad debts incurred in his business. *Gandy*, DC Wash., 1/25/57.

Can't deduct "interest" on debentures issued for preferred. For the purpose of transforming their interest into debt, preferred stockholders of taxpayer exchanged their 2% preferred for "preferred debentures." The district court found new certificates were not indebtedness—there was no fixed maturity and they were junior to general creditors. This court affirms. *Beaver Pipe Tools, Inc.*, CA-6, 1/4/57.

Farmer's advances to marketing corporation nonbusiness. Taxpayer-farmer advanced about $46,000 to a corporation which he helped organize to engage in the business of shelling and marketing peanuts. The Tax Court finds that the advances were loans rather than contributions of capital. The fact that a bookkeeper of the corporation recorded part of the advances as donated surplus, or that no notes were given or interest agreed upon, was not controlling. However, taxpayer is entitled to a nonbusiness bad-debt deduction only. He was not in the business of lending money to corporations generally. *Gulledge*, TCM 1957-29.

Stockholder who guarantees corporate product can deduct payments to purchaser. Taxpayer personally guaranteed that equipment sold by the corporation of which he was a principal stockholder was suitable for the purchaser's needs. Upon threat of suit under the guaranty, taxpayer entered into a settlement agreement and paid a compromise amount. The district court held the payment fully deductible. Upon stipulation of the parties that the issue is controlled by *Putnam* (352 U.S. 82), the loss is allowed only as nonbusiness and therefore capital. [The *Putnam* case held that loss upon guaranty of corporate obligations is bad debt. *Ed.*] *Durden*, CA-5, 2/22/57.

Loans to family corporation nonbusiness debts; guaranty loss not available until creditor proceeds against security. Taxpayers, family members, were in the shipbuilding business. Advances to their corporation which became worthless were held to be nonbusiness bad debts. Taxpayers were not in the financing or promoting business. They also guaranteed a corporate bank loan by pledging stock. A loss claimed in 1946 was disallowed. There was no sale of the stock or any other action taken by the bank with reference to the pledge until after 1946. *Wheeler*, CA-2, 2/25/57.

Payments to widow-stockholders of family corporation are dividends, not gifts. Payments by a corporation owned by a closely knit family to the widows of deceased members who had inherited stock in the corporation were found on the facts to be intended as distributions of corporate earnings and were therefore taxable as dividends to the widows. The deceased husbands of two of the widows were officers; the husband of the third was not. The duration of the payments was not limited. This court affirms. *Lengsfield*, CA-5, 2/27/56.

Exchange of assets for stocks and "notes" nontaxable; "notes" are contributions to capital. A husband and wife transferred all the assets of their partnership (value: $75,000; adjusted basis: $46,000) to a corporation organized by them. Stock was issued then, but notes are not mentioned in the records until three years later. Taxpayers claimed the notes were boot, the exchange taxable and basis of assets stepped up. The court finds the assets were transferred as risk capital; there was no true debt. Interest paid on the notes is disallowed as a corporate deduction and the corporation moreover has the partnership's basis. *Murphy Planing Mill*, TCM 1957-55.

Groman rule not applicable to "alter-ego" subsidiary (old law). In *Groman* (302 U.S. 82) the Supreme Court denied tax-free status to the acquisition by Glidden Corp. of the assets of an Indiana corporation. The assets went to a newly formed subsidiary of Glidden, and the Indiana stockholders got cash, Glidden stock and stock of the new Glidden subsidiary. The Court reasoned that the Glidden subsidiary was not wholly owned by Glidden; therefore, there was not sufficient continuity of

interest. In the case here at issue, the transaction was the acquisition by Allied Stores of the assets of Davis. After the deal was arranged, Allied requested transfer of Davis assets direct to a wholly owned operating subsidiary. Each of Allied's chain of stores was a separate corporation. The court holds the exchange is tax-free. Allied's subsidiary here was wholly owned and a mere alter ego of Allied. Simply because the assets went to it, not to Allied, should not make the exchange tax-free. [Section 368 of the 1954 Code specifically includes as tax-free the acquisition of assets for stock of the acquiror's 80%-or-more parent. *Ed.*] *Jones,* DC Ohio, 1/30/57.

No allocation of income where profitable soap business purchased by loss movie corporation. Enterprise, a motion-picture company, defaulted on its bank loans, and its stock was taken over by the lending bank. The bank advanced additional funds to Enterprise, which had a sizable loss carryover, to purchase all the stock of taxpayer, a successful unrelated soap manufacturer, and to take over all of its operations. Pursuant to plan, Enterprise bought taxpayer's stock, took over its assets, and started soap-manufacturing operations on April 30, 1952. It reported a net profit from operations for the period ended December 31, 1952 of some $1,400,000. However, because of loss carryovers which it had from its former motion-picture business, the soap profits floated away tax-free. The Commissioner assessed taxpayer on these profits. The Tax Court refuses to uphold. Enterprise, and not taxpayer, conducted all the soap operations, having acquired taxpayer's assets in an arm's-length transaction for the valid business purpose of realizing future earnings to repay its bank indebtedness. Furthermore, the Commissioner's reliance on Sections 15(c) and 129 is also held to be misplaced. Section 15(c) applies to the $25,000 surtax exemption, which issue was not raised, while Section 129 applies only to an "acquiring" company and not to an "acquired" company which taxpayer was. *T. V. D. Co.,* 27 TC No. 108.

Rental paid to related entity disallowed as excessive. The stock of taxpayer-corporation was held by one trust while the building it occupied was owned by a second trust. The same persons were trustees and beneficiaries of each trust. In view of the close relationship of all the parties and the absence of any independent trustee, the court holds the leasing arrangement was not an arm's-length transaction. Accordingly, it disallows as a corporate deduction rental paid in excess of what was determined as a fair-rental value. *Brown Printing Co.,* TCM 1957-37.

Parent cannot deduct capital loss carryover of liquidated subsidiary. A personal holding company acquired all the stock of a subsidiary in 1948 and liquidated it in 1949. Even though the parent filed a consolidated income tax return with the consent of the affiliate for 1949, it cannot use as a carryover any of the net capital loss sustained by the affiliate in 1948. The court reasoned that the affiliate's deductions could be used only by it, that the existence of the affiliate was terminated by liquidation, and that it did not survive as a component of the parent. *Patten Fine Papers, Inc.,* 27 TC No. 94.

Can't deduct as rent indirect payment of profits to owner. Taxpayer-corporation, a Ford agency, was wholly owned by Wade. He made an agreement with his wholly owned realty company to construct a building for lease to the taxpayer-agency in return for half the agency profits. The realty company also agreed to pay Wade a 6% return on any monies invested in the agency. The Tax Court held the actual rent paid by taxpayer and deductible by it was limited to half of the agency profits. The 6% returned by the realty company to Wade was not rent; it was an indirect distribution by taxpayer of its profits. This court affirms. *Wade Motor Co.,* CA-6, 2/15/57.

Partners transfer business to new corporation and simultaneously sell its patent; sale and depreciation on stepped-up basis upheld. Taxpayer-corporation was created to take over the business of manufacturing television tuners invented by its owner. Simultaneously, it purchased his patents and patent applications for a price based on future production and payable in installments. The Commissioner argued that in reality the patents were contributed to capital. The district court upheld the sale. This court remands. The district court grant of summary judgment was improper. Conflicting inferences could have been drawn from the evidentiary facts; therefore, the taxpayer was not entitled to a summary judgment. *Sarkes Tarzian,* CA-7, 2/7/57.

Administrative fees charged by affiliate allowed as reasonable. From the time of its formation in 1944 until 1947, taxpayer-corporation operated with a skeleton crew. A company which owned 50% of taxpayer's stock furnished staff, management, and a wide variety of services to or for its benefit. Payment by taxpayer to the company of administrative fees ($714,000 over the three-year period) is allowed as reasonable in view of the services performed, notwithstanding that the sum was arrived at in negotiations that were not conducted at arm's-length. *Waring Products Corp.,* 27 TC No. 114.

Partner's brother's stock constructively owned under attribution rules. The 1950 Revenue Act provided that gain on the collapse of certain corporations was ordinary income to stockholders owning more than 10% [5% in the 1954 Code. *Ed.*] of the corporation's stock. In determining stock ownership, the law also provided that an individual is considered as owning stock held by his brother and by his partner. Taxpayer in this case owned 5% of the stock of a collapsible corporation, his partner owned 5% and the partner's brother owned 6⅔%. Thus, unless the partner's brother's stock is constructively owned by taxpayer, he did not own more than 10%. The court states merely that he does constructively own the partner's brother's stock. *Butler,* DC Ala., 2/20/57.

Section 102 tax sustained; corporation failed to meet burden of proof (old law). Taxpayer, a sand and gravel corporation, was found by the Tax Court to be subject to Section 102 penalty surtax for the years 1945 to 1950. It failed to show that its accumulated earnings and reserves of over $6,000,000 were not in excess of the reasonable needs of the business. Taxpayer claimed it needed reserves as a self-insurer, but offered no evidence of the amount. A report on proposed expansion was prepared in 1953 and was obviously based on conditions and plans long after the years in question. The reserves set up on the books for expansion and other contingencies were far less than amounts claimed here as reasonable. It was admitted that the failure to distribute

earnings saved the controlling stockholders almost $1,200,000. This court upholds most of the Tax Court's computations. It remands the case for further findings on two issues. The Tax Court erred in holding that no reserve was required to permit it to go into another line if forced by competition. If it reasonably believed it might be forced into another line, it was entitled to the reserve. That it would not do so voluntarily is irrelevant. Further, in computing the need for current working capital, provision should have been made for operating costs as well as overhead. *Smoot Sand & Gravel Corp.*, CA-4, 1/16/57.

102 penalty rejected; war earnings accumulated for future expansion (old law) [*Acquiescence*]. As a manufacturer of woodworking machinery, taxpayer had accumulated a very substantial undistributed surplus during World War II. The Tax Court held it was not subject to the Section 102 penalty; the accumulated earnings, taxpayer showed, were needed for postwar expansion and improvement of plant which was obsolete and unfitted for intense postwar competition. *Newman Machine Co.*, 26 TC No. 133, *acq.* IRB 1957-6.

Officer's large bonuses allowed as reasonable. Bonuses of $50,000 and $20,000 paid to a corporate official by a coal-producing company and a coal-sales organization are found to be reasonable in relation to the services actually rendered by the official in prior years for which he had been inadequately compensated. Accordingly, the bonuses were deductible as ordinary and necessary business expenses. Approximately 57% of the stock of the companies was held by the executive and his relatives. *Jewell Ridge Coal Sales Co.*, TCM 1957-30.

Taxpayer's evidence met burden on reasonable salary. Three officers received a total of less than $80,000 of salary. As criteria for testing reasonableness, the court lists these facts: qualifications, nature and scope of work, size and complexities of the business, salaries in similar concerns, economic conditions, salaries in prior years, the over-all situation. The evidence showed a history of similar salaries, that the officers had been employed for over 25 years and had worked long hours. This, the court holds, overcame the Commissioner's presumption. The only evidence the Commissioner presented to offset taxpayer's evidence was the testimony of an inexperienced revenue agent. This was insufficient. *Yuenger Mfg. Co.*, DC Ill., 2/15/57.

Officers' salaries held reasonable. Taxpayer, a structural steel business, was managed by two brothers (with their mother sole owner of the corporation). The court found salaries paid to them were reasonable; testimony indicated they had greater duties and responsibilities than other executives in the same business. The method of compensation —low fixed salary with high year-end bonus—is found to be common in that industry. *Geiger & Peters, Inc.*, 27 TC No. 113.

Distribution of current earnings in liquidation not a dividend for PHC [*cert. den.*]. Taxpayer was a personal holding company prior to its total dissolution on June 14, 1948. Throughout the year, taxpayer had a deficit in its accumulated earnings and profits, but it did have current earnings and profits. Taxpayer contended that the current earnings and profits distributed in dissolution were dividends for the purpose of computing the paid credit personal holding company surtax. The district court agreed, saying that by complete liquidation it got current earnings into the hands of its stockholders and satisfied the intent of Congress in imposing a surtax on undistributed earnings. The district court noted that the Commissioner had changed his position on this issue in 1954. An *IT*, issued in 1937 and in effect while the taxpayer liquidated, supported taxpayer's argument. This court reverses. Only dividends are available for credit, and the Code clearly distinguishes between a dividend and a distribution in liquidation. *St. Louis Co., cert. den.*, 2/25/57.

Parent cannot use affiliate's capital loss for PHC tax. There is no authority to permit filing of a consolidated personal holding company tax return. Therefore, the Tax Court holds, in computing the personal holding company tax for 1949, a parent cannot reduce its net long-term capital gain by a net capital loss sustained by its affiliate even though a consolidated income tax return was filed for the year. *Patten Fine Papers, Inc.*, 27 TC No. 94.

Capital gain on movie-producing corporation collapsed in 1944 (old law) [*Non-Acquiescence*]. Pat O'Brien, Phil Ryan, and one Howe formed Terneen Corp. in 1943 to produce "Secret Command" starring O'Brien. Columbia Pictures agreed to distribute the film. The picture was completed in July 1944 and Terneen was dissolved a month later. The shareholders received Terneen's "right, title, or interest in the film" in liquidation which they valued at $150,000, and paid a capital gains tax on the difference of such sum (plus cash received) and the cash basis of their stock. The Commissioner's arguments that Terneen was not a bona fide corporation, and in the alternative, that the dissolution and assignment of assets was without substance, were overruled. The Tax Court pointed out that no inference could be drawn from enactment of the collapsible-corporation provisions in 1950 that gains arising from an alleged collapsible corporation prior to January 1, 1950 were taxable as ordinary income. This is not a case of collection of obligations which had no fair value on receipt and which have therefore been recognized as capital. [Present Section 341 relating to collapsible corporations would make gain on above liquidation ordinary income. *Ed.*] *O'Brien*, 25 TC No. 48, *non-acq.*, IRB 1957-8.

Collapsed corporation recognized (old law) [*Acquiescence*]. Pat O'Brien, Phil Ryan and one Howe formed a corporation to produce a movie starring O'Brien. One month after completion, the corporation, Terneen, was dissolved and the stockholders received the film in liquidation. The Tax Court recognized the corporation as bona fide. [Present Section 341 makes the gain on liquidation of a collapsible corporation ordinary income. *Ed.*] *O'Brien*, 25 TC 376, *acq.*, IRB 1957-8.

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TAX STRATEGY NEWS OF THE REVENUE SERVICE

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Tips on how to deal successfully with revenue agents during all pretrial stages

by HAROLD R. BURNSTEIN

The average practitioner learns the knack of dealing with revenue agents the hard way. Only after trial and error can he be sure that he knows the meaning of each step of revenue agent procedure, that he is bringing the client into the discussions at the right time, or that his request for a conference with a group chief is well advised. Because this knowledge is not easily obtained, Mr. Burnstein's very practical suggestions here will be of considerable help to many practitioners.

THERE ARE about 836,000 corporation income tax returns filed in a year. Of these, 125,000 to 150,000 are examined. That is roughly one in seven of the corporation income tax returns are examined. Individuals and partnerships file about 60 million income tax returns. Of these, 1.5 to 2 million are examined, or roughly 1 in 30.

How are the returns that are audited selected? Some people have the idea that their 1956 return will be compared with their 1955 return and that a difference between the two will cause them to be investigated. This isn't so. Returns are not compared with previous years' returns in order to determine if an examination is necessary.

Although the procedure is not uniform throughout the nation, the procedure at the present time in the Chicago office is this. When a return is filed, it goes into the collection routine. Then it goes to the classifiers who scan each return to determine if it should be examined. One test they use is the size of the income. If an individual has income over $25,000, there is a good chance his return will be audited. Another test is the kind of deductions taken. For example, the classifier will check for large deductions for travel and entertainment, casualty losses from fire, and deductions for medical expenses. The classifier attaches a sheet to returns and checks off the items which he thinks deserve scrutiny.

At various times, the Service has used the audit-sample idea, that is, the use of a random sample in determining returns to be examined.

The Service tries to see that all groups are examined. Even the wage earner's return may be examined as to the number of dependents he takes. Of course, the lower the income, the less likelihood there is of examination. But no one is immune.

At the present time, every income tax return showing an overpayment of $200 or over and asking it to be refunded is audited. Many accountants and lawyers who prepare returns do not ask for a refund of $200 or over. Instead, they ask that the overpayments be applied to next year's tax. By doing this, they avoid a pre-refund audit.

Examinations arise in other ways. A claim for refund will nearly always bring on an examination. Therefore, many practitioners refuse to file claims for small amounts. Some claims for a few hundred dollars have resulted in asserted deficiencies of thousands of dollars.

Information returns may bring on an audit. About 200 million information documents are filed during the year. An employer files an information return for all salaries paid. Corporations report all dividends and interest paid of $100 or over. These reports are matched with the returns of the recipients to see if they are reported. I know of a case where an individual had 500 shares of a stock which cost him $15. The corporation intended to dissolve and declared an initial liquidating dividend of $10. The $5,000 did not have to be reported on his return because it represented a reduction from cost. However, the corporation reported the payment to the Government and because the stockholder's return made no mention of the receipt of the $5,000, it was audited.

Many times, agents file information returns. In examining a return, the agent will learn of a large payment made by the taxpayer to another. The agent may file an information return on the payment and the other will be examined.

Finally, there are the "rap letters." All rap letters are investigated. A disgruntled employee, an envious neighbor, a jilted girl friend may write a letter to the Service. Some do it to get even. Some do it for money. The latest figures show 3,000 claims for rewards filed in the year ended June 30, 1955. In the same year, the 576 that were allowed resulted in rewards totaling $602,817. This average, as you can see, is better than $1,000 per reward. Of course, the rewards are taxable. One recipient made the mistake of not reporting a reward and was caught himself.

After the returns are selected for examination, those that require examination of voluminous books and records go to field audit. Others go to office audit.

Typical office audit

One day when you are sitting in your office the telephone rings. It's Mr. Jones. He has just received a letter telling him to appear at Room 1 at the United States Court House and to bring evidence to substantiate his deduction for medical expenses. He is rather excited. So you calm him down. You ask him to send you the letter, you hang up and then you decide what you have to do.

The first thing you do is to make sure you are admitted to practice before the Treasury Department. Unless you have the blue card showing that you are, office audit won't talk to you. Every attorney and CPA is eligible for admission, plus others who qualify. Applications for admission are carefully investigated. References are either interviewed or checked by letter. Another point of

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importance is that the application requires a statement of whether tax returns were filed for the three preceding years and whether you owe any prior years' Federal tax. The agent who examines your application pulls your returns as part of his examination. On admission, each enrollee secures a Treasury card good for five years. It is this Treasury card which you must show to the examining agent on request.

If you intend to go to the conference yourself, you also need a power of attorney from the taxpayer and a fee statement which asserts that the practitioner has (or has not) entered into a contingent or partially contingent-fee arrangement. If the fee arrangement is wholly or partially contingent, the practitioner must file details of the agreement with the Director of Practice.

In only one situation is a wholly contingent-fee agreement permitted. That is when a client's financial status is such that he would otherwise be unable to obtain the services of professional assistance. Of course, you would have to justify a wholly contingent-fee arrangement with the Director of Practice.

A partially contingent arrangement can be entered into if there is provision for a minimum fee or retainer. The minimum fee need not be paid in advance but must be paid irrespective of the outcome of the case. It must also be substantial in relation to the possible maximum fee. It must also be reported to the Director of Practice.

Last, but not least, don't forget the evidence. In the hypothetical case, Mr. Jones was asked to substantiate the medical expenses. Have Mr. Jones accumulate all the canceled checks and doctor bills that he has available.

I am asked many times whether the tax man should take the taxpayer with him to office audit. I say that the answer depends upon the client. Many clients prefer to have nothing to do with their cases. Others are eager to fight for their rights. If the client is a good salesman and can take care of himself, you may suggest he go alone armed with the valuable advice that you can give him. But ordinarily I prefer to go alone. I find I do better without the client. Most clients talk too much and hurt their own cases. Other times, agents ask questions which require well-thought-out answers. If the taxpayer is not along, the attorney can plead ignorance and promise to come back with the answer. The only time I would take the client to office audit would be when substantial travel and entertainment expenses are involved, the substantiation is weak, and the taxpayer is a good salesman and can explain to the agent how, why, when and where he had to spend on travel and entertainment.

When you, your client, or both go to the office audit, you are assigned to an agent who takes out the tax return and asks you for your evidence. The most important point the tax man must bear in mind at this time is that he must be pleasant. If he wants to represent his client as effectively as possible, he must not be arrogant. Agents like to feel important, and nothing irritates them more than someone who tries to talk down to them or who is nasty.

Office audit is more a bargaining session than anything else, and as in all bargaining sessions, the more time that you take, the better. The agent tries to do as many audits as he can during the day. He is apt to give you a good settlement just to get rid of you. Therefore, don't be in a hurry but use all your powers of salesmanship on him. Let's suppose you have been with the agent for several hours, you have used all your powers of persuasion and still have been unable to get a satisfactory settlement. Then it's time to suggest that you talk to his group supervisor.

Let me interject a word of caution. As a general rule, it is best to settle your cases at the lowest possible level. The reason for this is that it will save the client interest and fees. It might also avoid a contest as to other issues which are not yet present in the case but which might be brought out higher up. Also, the agent likes to have a good record of closed cases and may be more willing to make concessions than will higher-ups. An agent is more sympathetic to equitable arguments than his superiors. He does not do a lot of research and many times he assumes that the law and equities go hand in hand. Finally, if you don't settle, the agent will ordinarily disallow more than he was willing to disallow if a settlement were reached.

Let's suppose, however, that the agent is definitely unreasonable or that there is a point of law involved which he does not or cannot concede. Suppose, for example, that the taxpayer is a cardiac case, that the doctor has told him he cannot walk up stairs, and that one of the items claimed as a medical expense is an elevator to get the taxpayer to the second floor of his house where his bedroom is located. The agent will allow you nothing for this expenditure and will claim it is a permanent improvement. You will refuse to settle, and your client will receive a ten-day letter.

The ten-day letter is a statement of the proposed adjustments to net income and a notification that the taxpayer has ten days in which to request an informal conference with the group supervisor. From this point on, office audit and field audit are handled in the same way.

Field audit

Revenue Agent Smith telephones to tell you that he has the Jones Manufacturing Company return for audit and that Mr. Jones has told him to call you. You make an appointment and meet him at the Jones Manufacturing Company office the next morning at 9:00.

The first thing you do after Revenue Agent Smith comes in is to ask to see

STEPS TO TAKE WHEN YOU MEET THE SPECIAL AGENT

WHAT TO DO when a general agent or a Special Agent arrives to start the investigation has long been a troublesome problem. This is how Mr. Burnstein advises that the meeting should be handled.

I should say this, and I cannot be too emphatic about it, but tax men sometimes don't realize that this is a very crucial stage, and many fail to take advantage of the rights which they should at this stage of the game. And they don't because they are afraid that the agent will be suspicious if they turn him away. I don't think the tax practitioner has to be afraid of that. If the man shows a Special Agent's card, I think the practitioner could show enough sense to say, "I am sorry; under the circumstances we cannot let you have anything, but I would like to consult with the client and we will call you and tell you our position in this matter." After consulting with the client you may find out there was nothing there, and allow him to go ahead. Or you may decide to take advantage of every right you have, and make the Government fight for everything.

WHEN DOES AN AGENT GO TO PAST YEARS' RETURNS?

ONE QUESTION on the minds of many practitioners was asked Mr. Burnstein: That is: "what happens when an agent does find an irregularity in the current return? Is there a likelihood he will backtrack for a number of years to see if there are any irregularities in those returns, too?"

Mr. Burnstein's answer

I might say in the initial classifying he does not compare them, but it is usually a rule that when an agent goes on to an audit that he is to audit more than one year. What he usually does is, when he comes out for the year '55, to ask the client for the retained copies of perhaps the '54 and '53 returns. And he, in all likelihood, would audit all three returns. If he did find something in '55 that was applicable to '54 and '53, he would probably make the same adjustment.

He would also probably look at all previous audit reports by the Service. It keeps all the revenue agents' reports. I know that many agents, before they go on a job, especially if it is to a corporation that has been audited year after year, look up the old audit reports to see the type of adjustments. ☆

his identification. This is a very important action, and I cannot emphasize it enough. In looking at his card you must see if his title is revenue agent or Special Agent. The Special Agents work out of the intelligence unit. Their function is to prepare a case for criminal prosecution. If you see that Smith is a Special Agent, he is there because he suspects fraud. At this point, the case takes a distinctive turn. You should find out what information he wants and then send him away without giving him any until you have talked to the client. Never, and I emphasize never, allow a special agent to begin his examination without considering the case thoroughly.

But let's suppose that Smith is a revenue agent. You then find out what information he wants and get it for him. If the examination will not take more than a day, you may want to stay with him, but if the examination takes longer and you intend to leave, you should give the client's personnel simple instructions. (1) Give the agent anything he wants. (2) Do not volunteer any information. (3) Do not give him anything he doesn't ask for. (4) Write down what he asks for and set apart those records that he looks at.

During the agent's examination you can check with the client every day and find out what the agent is doing and in what aspects of the examination he is interested. After the agent has completed his examination, he will visit you to discuss his proposed adjustments.

In talking with the agent about his proposed adjustments, it is important to bear in mind that the agent is interested in a "change" case. That is, he wants to increase taxable income in some manner in order to secure additional tax. There are many ways he can increase taxable income, some in ways less painful than others. For example, he can move a deduction from one year to another. The question may be when stock became worthless or when a legal fee is to be accrued. Such adjustments are the least painful (assuming the same tax bracket in each year). They cost only six per cent interest. Or he may capitalize repairs and allow depreciation on them as improvements. There is also the usual haggle over travel and entertainment expenses of the officers.

It is usually preferable to settle the case with the agent, and every attempt should be made to do so. Of course, there is considerable diversity among agents as far as ability is concerned. The results of your attempt at settlement will depend to some extent on the agent. The usual procedure that I follow when the agent has presented me with his list of proposed adjustments is to plead ignorance and ask for time to investigate them to see if they have merit. Usually the kind of adjustments proposed by a field agent are more complicated than those proposed by office audit and more time is needed. The agent won't mind giving it to you.

The first thing to do is to get the facts on the particular items troubling the agent. The facts are elusive, and the agent may not have secured all of them. He may have made a mistake of fact or have overlooked a crucial fact. Remember the agent is not a lawyer. He is interested in tangible evidence such as contracts, canceled checks, bills and vouchers. This type of evidence is persuasive.

The agent is also impressed by cases which are factually similar; they will weigh heavily with him. By showing him these cases, you may be able to settle doubtful cases.

On your next meeting with the agent you will present the facts to him in their most favorable light. You will show him cases and perhaps even Revenue Rulings, or a law memorandum. You will argue the equities with him and you will, in general, use all the powers of persuasion that you have. On the other hand, you will not be rude, nasty or arrogant, nor impugn his motives.

A word of caution at this stage of the negotiations. You must know your case and your law well enough so that you don't make any admissions of fact which may prove embarrassing by giving the agent ammunition in raising a new issue.

After you have presented your case to the agent, you will know what kind of impression you have made. At this time, the agent may tell you what adjustments he will make if you will settle the case. It is always best to get a proposal from him first. If he is adamant in his position, then you must make a proposal.

It pays to be realistic in this stage and give the agent a change in net income. You cannot go too far off if you offer to concede some of the adjustments which are the less painful ones — the capitalization of repairs, the switches of deductions between years if the agent will concede the others. It is all a matter of compromise. And as in all compromises, the tax man must be able to evaluate his case in order to see whether he should agree.

If you do reach an agreement, he will prepare a Form 870 which is an agreement form on which are listed the amounts upon which the parties have settled. This will have to be signed by the taxpayer.

Suppose, however, you don't reach agreement. You then will receive a ten-day letter showing the proposed adjustments to net income.

The next step

The next step is the Group Chief conference. The Group Chief is similar to a foreman. He supervises a group of agents and also serves as a conferee in attempting to resolve the differences which arise between the agents and the taxpayers.

The first question is: shall you avail yourself of the informal conference with the Group Chief? My experience is that this conference does not usually produce results. But most of the time you lose nothing except your time. Especially in cases involving travel and entertainment expenses and other simple issues, it can be effective.

Two factors cause the group supervisor conference to fail in the more difficult cases. First, the group supervisor doesn't have the time and, therefore, is not equipped for the more difficult case. Second, since he is the agent's boss, there is a close working relationship between them and he hesitates to reverse his man. For this reason, the Service recently changed its informal conference setup and arranged to have the more difficult cases assigned to other people who can deal with the more complex situations [see 5 JTAX 224].

The informal conference takes place in the group supervisor's office with the agent present. Usually the arguments previously used by the agent and the lawyer are rehashed, but the group supervisor is more objective and impersonal in his views. If a reasonable settlement can be secured at this stage, it is best to take it for the reasons which I have previously given.

In the event of failure to agree, a 30-day letter will be issued. This consists of the agent's report showing the proposed adjustments and the proposed addition in tax, together with a letter that affords you 30 days in which to decide your course of action. You may either sign the agreement form and thereby close the case, file a formal protest in writing or wait for the statutory notice to be issued to you.

Assuming that taxpayer has no intention of paying the tax, the attorney has two alternatives. He may either file a formal protest and go to the Appellate Division or get a statutory notice and file suit in the Tax Court.

Appellate Staff

If you file a formal protest, you go up to the Appellate Staff in the Service. Now you begin the formal stage. The Appellate Staff is the last appellate body to consider the case within the administrative framework of the Service before it goes to trial.

If you ignore the 30-day letter, you will get the notice of deficiency. You will then either decide to pay and sue on a claim for refund through the District Court or Court of Claims, or to file a suit in the Tax Court, which stays the assessment until the case is decided.

Suppose you want to stay within the framework of the Service. You need not decide here whether you want to file a formal protest or want to go to the Tax Court. If you go to the Tax Court, the same agency, namely the Appellate Staff which has jurisdiction over the case if you file the formal protest, has jurisdiction over the case for settlement purposes. If you file a protest, the case is called a nondocketed case. If the case is pending before the Tax Court, it is called a docketed case.

As a personal preference—and I think most experienced practitioners agree — I usually prefer to bypass the Appellate Staff entirely and go directly to the Tax Court. I have three reasons for this. In the first place, you haven't waived any rights, for you have the same man considering whether you can settle the case or not, the man on the Appellate Staff. Second, I think when you are in the Tax Court you show you mean business. The Government recognizes that if the case is not settled at this time, it is going to be tried, and there is more of a tendency to settle the case when everyone knows it is going to trial. Third, there is a question of burden of proof. The men on the Appellate Staff are experienced men, they are very intelligent, and they know what is going on as far as tax controversies are concerned.

There may be something in your case which you know nothing about, which the agent has not raised, and which will be brought out if you go to the Appellate Staff first. And if it is brought out at that time, it is put into the notice of deficiency, which represents a prima facie case, as it were, for the Service. In other words, the taxpayer has the burden of proving that the notice of deficiency is wrong.

Suppose in the case that I was talking about, the medical-expense situation, that you did not reach agreement on the medical expenses, and that the thousand dollars of medical expenses were disallowed. If the notice of deficiency were issued on that basis, the burden of proof on the taxpayer would be to prove that he spent this thousand dollars for medical expenses. But suppose you went to the Appellate Staff first, and suppose, as the appellate adviser goes into the case, he finds something else. If he puts that in the notice of deficiency, the burden of proof again is on you.

Now, suppose you skipped the Appellate Staff. The same man who gets the case in the nondocketed status gets the case when it is before the Tax Court. Suppose again, he finds the other issue. In that case, the Government has to raise the issue in the answer, which shifts the burden of proof from you to it. For that reason, when I feel that the case is very difficult to settle or that there may be things that I don't know about (or that I do know about), I will go directly to the Tax Court.

HOW TO SETTLE ITEMS WHICH "CANNOT" BE SETTLED

AN ATTORNEY in the audience asked Mr. Burnstein the following question: "In your example, you cite a medical expense which may be allowed in part as a settlement. What about situations which would appear to be susceptible only to a yes or no conclusion. For example, should a gain be taxed as an ordinary or a capital gain: There doesn't seem to be any room in between to settle."

Mr. Burnstein's answer

In those cases, of course, you are at a disadvantage, but there are many times when at first blush you say, "It looks like all or nothing." But with some ingenuity you sometimes can work it in a different way and show the agent how to do it.

Let me give a good example of this. Suppose it is a question of a capital gain and suppose it involves the sale of property by a stockholder to his wholly owned corporation. You might say to the agent: "I will tell you what we will do. If you will agree that it is a capital gain, let us say the selling price is a hundred thousand dollars, if you will agree that it is a capital gain to ninety thousand dollars, I will agree that ten thousand is a dividend, because the hundred thousand dollars was $10,000 in excess of market value." That is the type of thing that the practitioner has to look for, and that is the type of thinking that settles cases. You have to find a formula and the key to the settlement of the case. Sometimes this ingenuity works, but sometimes even that fails too. ☆

There are times when the client doesn't want to file in the Tax Court, doesn't want his name on the docket, and doesn't want the publicity. After all, every case before the Tax Court is open to the public. The client may refuse. He may not want to go there. He may want to settle the case under any conditions. In that case, your hands are tied. You have to go to the formal protest and to the Appellate Staff of the Internal Revenue Service. ☆

New procedural decisions this month

Injunction against collection of jeopardy assessment granted; agent had mental breakdown. In 1952, taxpayer was indicted for criminal understatement of income for 1945 and 1946. A jeopardy assessment had been made in September 1955 of some $3 million, and it was later reduced to $2 million in November 1955. The district court found the assessment completely arbitrary and capricious and granted an injunction against collection of this assessment. This court vacates the injunction order and remands. The district court's grant of summary judgment was improper; it should have tried the issues of fact involved. Moreover, it should have taken cognizance of the power given to the Commissioner in 1953 to abate a jeopardy assessment. *Homan Mfg. Co.*, CA-7, 2/4/57.

Improper to dismiss indictment because tax liens prevent hiring accountant. In 1951, the Government tied up all of defendant's assets through jeopardy assessments and tax liens. In 1953, it indicted him. Because the Government's criminal case was founded on net-worth computations, the defendant claimed he could not properly defend himself without money for an accountant. The district court agreed and ordered the indictment dismissed. The Seventh Circuit reversed on October 31, 1956. Now on rehearing en banc, it refuses to change its position. Not until the trial is had can it be known whether it was fair. Defendant might be able to borrow, he might receive free assistance, or he may obtain help in any of a number of ways. It is established policy to base protection of the right to a fair trial on the actual trial record, not on inferences drawn from pretrial affidavits. One dissent: The Government's tactics in this case are so unfair as to violate due process. Under these peculiar circumstances, the district court was justified in dismissing the indictment. *Brodson*, CA-7, 2/7/57.

Can inspect income tax returns in treble-damage action under antitrust laws. The plaintiff contended that the books and records from which the income tax returns were prepared, and which were submitted to the defendant for inspection, should suffice in the absence of any indication of inaccuracy. The court allows inspection of the income tax returns, since plaintiff's income is one of the issues of the case. *Court Degraw Theatre, Inc. v. Loews, Inc.*, DC NY, 1/29/57.

Cashier's check for payment of estimated tax became property of the Government on delivery. Taxpayer paid $12,000 of his 1945 estimated tax by cashier's check. The check was never presented to the bank for payment. Both taxpayer and the Government demanded the sum from the bank. The court holds that since the check became the property of the Government on delivery, the Government may recover the full amount less the bank's legal expense. *Marik*, DC Cal., 2/11/57.

Penalty for willful failure to file is constitutional. The court characterizes as without merit taxpayer's argument that the penalty for willful failure to file a declaration or to pay estimated tax is unconstitutional as usurping the judicial function of levying penalties. *Walker*, CA-5 2/5/57.

Record title holder was only fiduciary; decision opens beneficiary's year. While taxpayer was in the army, his father made a profit in real estate by using the son's funds. The Commissioner taxed the income to the father and refunded tax paid by the son. However, the father sued for refund and collected. The Commissioner assessed the son, who paid but now sues for refund on the ground that the assessment against him was barred by the statute of limitations. The court holds that the son's year was opened under Section 3801. It had been held in the father's case that they stood in the relation of trustee and beneficiary. Under Section 3801, these are related taxpayers, and since they have adopted at this point inconsistent positions, the Commissioner has the power to assess the son. *Ross*, DC Mass., 1/31/57.

Estimated payments on tentative return don't start statute. Taxpayer obtained an extension of time for filing its 1947 income tax return to July 15, 1948. A tentative return was filed March 15 and payments on account of the estimated tax was made at March 15 and June 15. The court holds that a claim for refund filed within three years of the final return is timely. It says that amounts paid on account of a tax to be computed in a return later are not "paid" until they are applied by the Collector to the tax involved. The payments here were held in a suspense account. *Budd Co.*, DC Pa., 2/20/57.

Ninety-day notice need not be sent by registered mail. The Commissioner determined a deficiency in tax and mailed a notice by ordinary mail to the taxpayer who received it the following day. The taxpayer sought to enjoin collection on the theory that the statute required notices by registered mail. The court holds that the statute authorized notice by registered mail and is permissive, not mandatory. *Boren*, CA-9, 2/19/57.

Can't suppress information disclosed by accountant; he was taxpayer's agent. Taxpayer, a county clerk, also conducted an insurance business and prepared tax returns for others. When a Special Agent began to examine the returns he prepared, as well as his own returns, taxpayer engaged a lawyer (who soon dropped out) and a public accountant. In the course of many interviews, the accountant disclosed much information about taxpayer's affairs. This information the lower court refused to suppress. There was no affirmative act of deception by the revenue agent or the Special Agent. Taxpayer knew that he was under examination, the disclosure was voluntary, and the accountant was taxpayer's agent and his disclosure was within the scope of his authority. That the accountant was not enrolled to practice before the Treasury is irrelevant. *Russo*, CA-2, 2/8/57.

Issues could have been raised in Tax Court; can't bring them before district court. In a district court suit to collect a deficiency in estate tax which had been

determined by the Tax Court, taxpayer raised defenses based on the deduction of additional administration expenses and the valuations of certain assets. Since these points could have been raised in the Tax Court proceeding, that decision is res judicata. However, taxpayer could question the computation of interest on the deficiency, an issue which was not before the Tax Court. *Herter,* DC NY, 2/11/57.

The requirement in the Regulations of an election to claim amortization of premiums upheld. The estate was denied deductions for amortizable premiums because it failed to make the election in its first return as prescribed by the Regulations. The Regulations are held not to be "clearly arbitrary and unreasonable" and hence had the force and effect of law. The trustees argued that the Regulations were unreasonable because they would have required an election by them prior to filing the estate tax return in which the optional valuation date might be elected and the entire tax picture changed. *Woodward Estate, Barnhill, Ex'r,* CA-5, 2/27/57.

Disability benefits subject to Federal tax lien despite state exemption. Taxpayer held insurance policies providing monthly payments on disability. In 1953, the insurance company agreed that he was disabled and admitted its liability, but it refused to pay because the Government had assessed some $263,000 against him two years earlier. The taxpayer brought this suit against the insurance company and the U. S. was joined as a necessary party. Although New York law provides that insurance benefits may not be seized to pay debts of the insured, the court holds that such a state exemption statute is ineffective against a Federal statutory lien. The court distinguishes its own decision in *Rowen* (215 F2d 641) wherein the proceeds of insurance policies on her husband's life, paid to his widow as beneficiary, were held not subject to the husband's unpaid income tax. The New York law applicable here was not an exemption statute; it was a declaration of the beneficiary's property rights. *Fried,* CA-2, 2/15/57.

Limitation of Tax Court jurisdiction affirmed; new issues barred on appeal. Taxpayer admitted the deficiency but contended that the income had been reported in earlier years. The court held it had no jurisdiction to determine whether an overpayment had occurred in earlier years. Even if the alleged overpayment had occurred, it did not excuse the failure to file an estimate and return for the taxable year under review. The appellate court affirms this decision and refuses to consider a new issue raised on appeal for the first time. This judgment of affirmance would not prejudice the taxpayer's new claim which could be entertained by the Commissioner. *Glowinski,* DC Cir., 3/7/57.

Return filed 3/16/49; deficiency mailed 3/15/52 timely. Taxpayer's 1948 return was received in the district director's office on March 16, 1949. A deficiency notice mailed to them on March 15, 1952 is held to be timely, since it was mailed exactly three years after the date the return was filed. The fact that 1952 was a leap year does not affect the three-year computation in any manner whatsoever. *Monaghan,* TCM 1957-34.

Based refund claim on goodwill value; "amendment" raising real-estate value is new claim. Taxpayer was formed by the merger of several companies in 1925. Its excess profits tax invested capital included the value of stock of the merging companies paid in for taxpayer's stock. The taxpayer filed a claim for refund on the ground that in valuing those stocks by valuing the assets they represented the Commissioner erred in his computation of goodwill. Subsequently, it filed an amendment claiming error in the valuation of land and buildings of those merged companies. The court holds that the "amendment" raised a new issue and was a new claim. The court agrees that the Commissioner was wrong in the real-estate valuation but since the claim was not made within three years of the filing of the return only payments within two years of the filing of the claim can be refunded. *General Outdoor Advertising Co.,* Ct. Cls., 3/6/57.

IRS states policy with regard to securing consents to extend limitations period. The Service has made known its policy of keeping to an absolute minimum consents obtained from taxpayers to extend the statutory period of limitations. An examining agent must have the approval of his group supervisor prior to requesting the extension, and approval will not be granted unless the agent has made previous contact with the taxpayer. However, in appropriate cases, consents may be requested: for example, where the issue is similar to one being litigated; where disagreement exists regarding some complex or intricate issue; or where a net operating loss is to be applied as a carryback, and sufficient time does not remain within the statutory period to resolve the question. *Rev. Proc.* 57-6.

Can file refund claim based on bad-debt deduction within seven years after due date of return. Taxpayer claimed a larger bad-debt deduction than shown on his original return. The claim was timely, having been filed within the seven-year limitation period, but to the extent that the tax had not been paid within two years of the filing of the claim, the 1939 Code did not permit interest on the refund. *Gandy,* DC Wash., 1/25/57.

TC petition of nonexistent committee dismissed for lack of jurisdiction. An unincorporated committee organized to "secure justice in the Rosenberg case" dissolved prior to the mailing of the notice of deficiency. However, a petition to the Tax Court was filed by the former treasurer. The court holds that the authority of an unincorporated association to sue or to be sued in the name of its officers derives from the agency relationship. As the association was dissolved prior to the notice, its former treasurer could not institute the Tax Court proceeding by filing a petition. *National Committee to Secure Justice in Rosenberg Case,* 27 TC No. 102.

Method of computing alternative tax for a PHC is a legal issue. Applicability of the alternative tax in the computation of the personal holding company surtax is a legal question rather than

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just a matter of arithmetic. Therefore, taxpayer's failure to raise the question in his petition prevents the court from hearing it. *Patten Fine Papers, Inc.*, 27 TC No. 94.

General order to third party to produce all records is illegal search and seizure. Defendant is the surviving spouse of one who appears to have been the moving factor behind a building company, whose books and records were subpoenaed by the Special Agent investigating the tax liability of two individuals who transacted business with the building company. She refused to produce any of the subpoenaed books and records on the ground that the Government might make a tax claim arising either out of the affairs of the building company or her deceased husband and attempt to pursue certain property which had been transferred to her by her deceased husband. The district court held that since such possible tax claim would be a civil proceeding, the Fifth Amendment would not excuse production of the books and records. Further, the question of the materiality of the books and records could be raised if at all, only by the one who is being investigated. The circuit court set aside the contempt order. It now withdraws its previous opinion but affirms its previous conclusion. It now rests on the proposition that a general search of a third party is an unconstitutional search and seizure. She should be questioned about documents in her possession and if any are relevant she should be ordered to produce specific ones. As to each document, she may also raise the question of self-incrimination. *Hubner*, CA-9, 1/30/57.

Taxpayer may waive notice of claim disallowance. Suit for claim disallowed must be brought within two years of notice of disallowance. The Service has prescribed a Form 2297, Waiver of Registered Mail Notification of Claim Disallowance, which a taxpayer will be asked to sign if he agrees to disallowance in whole or in part of a claim for refund. A taxpayer may execute the waiver with respect to a filed refund claim at any time prior to issuance of the registered notice. The two-year period for bringing suit will begin with filing of the waiver. *Rev. Proc.* 57-12.

Refund bears interest to payments despite prior erroneous offset. A Federal income tax refund was sent by the Service to the General Accounting Office and offset against a claim against the taxpayer by another agency. That claim was later denied by court order, and the GAO ordered the Treasury to make the refund plus interest. This the Treasury did, but it included interest to the date it sent the original check to the GAO. The Service now holds that the refund should include interest to the issuance of the second check as provided by the Code for all refunds. It is not significant that the refund is being paid from appropriations other than Service funds. *Rev. Rul.* 57-82.

Service can proceed against transferee; insolvency of transferor admitted. A father who owed taxes transferred his property to his daughter. The Government attempted to collect the taxes from the daughter. The district court dismissed the action because the Government did not exhaust its remedies against the father. This court reverses; it is apparent that proceeding to judgment and execution against taxpayer would be futile. *Russell*, CA-1, 2/27/57.

Widow, life insurance beneficiary, not liable for decedent's income tax. Decedent carried policies on his life which named his wife as beneficiary. He retained the right to change the beneficiary and to draw the cash-surrender value of the policies up to the date of his death. The Tax Court held that the wife was liable as transferee for deficiencies due on decedent's income. The Tax Court thus adhered to its position (affirmed in *Kieferdorf*, 142 F2d 723, cert. den., 323 U.S. 733; *Pearlman*, 153 F2d 560), despite other cases to the contrary (*Rowen*, 215 F2d 641 and *Tyson*, 212 F2d 16). The Sixth Circuit reverses. It affirms its position in *Tyson*, stating that the Tax Court was bound by it in cases arising in its circuit. Although for estate tax purposes, the beneficiary of the proceeds of a life insurance is a transferee, there is no comparable provision for income tax purposes. Turning to state law, the court finds that the deceased never had a property interest in the proceeds; nor can the cash-surrender value be touched since that was not what the widow received. The cash-surrender value is not merged into the proceeds. *Stern*, CA-6, 2/26/57.

Transferee liability reduced by commingling of funds. Taxpayer argued that she was not liable as transferee for corporate taxes because the waivers extending the time for assessment of tax were signed by her as treasurer after the corporation had been dissolved under state law. The Tax Court held that the Commissioner was entitled to rely on these extensions. This court affirms. Notice of liquidation, required by the Code, was not filed. The court finds that taxpayer is liable as transferee but not to the full extent of $75,000 withdrawn from the corporate account by her husband and deposited in his personal account. The account had a balance then of $37,000. He immediately bought her stock for $53,600. The court holds that in the commingling of the husband's funds it is unfair to assume that the entire $53,600 came from the $75,000; the wife is liable for the difference between $37,000 and $53,600. *Benoit*, CA-1, 11/16/56.

Assessment of transferees upheld; transferor's year open. The court upholds the Commissioner's assessment of a father's tax against his five sons who had received property from him. It was conceded that the time had lapsed during which assessments against the sons could be made under the provisions of the 1939 Code. However, the father's year was still open. The court cites cases in which transferees of a corporation were held liable for the corporation's taxes on the theory that in equity they received corporate assets subject to the corporate debt. The court applies the reasoning to this case. *Wilke*, DC Ohio, 12/18/51.

Interest on operating loss carryback claim runs from filing. Taxpayer incurred an operating loss in 1946 and filed in January 1947 a claim for refund of prior years' taxes because of the carryback, but it did not file the 1946 return until May 1947. The Code provided that interest on a loss carryback which was a tentative adjustment is not payable prior to the filing of the return for the loss year. But taxpayer here, the court holds, did not request a tentative adjustment; it falls under the general rule that interest on a loss carryback refund begins with date of filing the claim. Taxpayer is entitled to interest from January 1947, not May 1947. [The 1954 Code allows interest from the last day of year of loss. *Ed.*] *Landers, Frary & Clark*, Ct. Cls., 3/6/57.

INCOME TAXATION OF
Trust & estates
EDITED BY FERDINAND J. WOLF, LL.B.

How benefits from deferred-compensation plans are taxed at the employee's death

NOWADAYS, THE MOST valuable asset in the estate of many an employee is his rights under his employer's pension, profit-sharing or stock-bonus plan. The rules governing the income and estate tax consequences of these rights were recently discussed at a Saturday PLI forum in New York City by William M. Horne, Jr., of the Boston law firm of Warner, Stackpole, Stetson & Bradlee. This is what he said:

Estate tax—qualified trust

Payments to beneficiaries (other than the executor) under a qualified trust forming part of a pension, profit-sharing, or stock-bonus plan are excludable from the decedent's gross estate to the extent they are attributable to contributions or payments not made by the decedent. This exclusion does not apply to proceeds of life-insurance policies, the taxability of which is determined under Section 2042 of the 1954 Code. If the participant's estate rather than an individual is named as the beneficiary, the entire value of the payments to the estate will be included in the gross estate. Contributions made by an employer or former employer are not considered to be made by the decedent. Payments include those made under an annuity contract purchased by the trust, as well as payments made directly by the trust.

To qualify as excludable, payments must be under a plan which was exempt under Section 401(a) at the earlier of either (a) the decedent's separation from employment (whether by death or otherwise), or (b) the termination of the plan.

If the decedent contributed to the plan, the amount includible in his gross estate is that portion of the value of the payments which corresponds to his proportionate part of the total contributions. For example, if the decedent had contributed $10,000 and his employer had contributed $40,000 and the value of the payments to be made to decedent's beneficiary is $75,000, then one-fifth of the value, i.e., $15,000, would be includible. The amount includible is based upon the date-of-death value of the payments to be made to the beneficiary. Where payment is made in a lump sum, there is, of course, no discount factor. A lump-sum payment appears to be covered even though the section in the Code is entitled "Annuities." Only the commuted value of future payments should be taken into account.

Income tax—qualified trust

Capital gain treatment is accorded to payments from an exempt trust received by a beneficiary of a deceased employee if (a) the "total distributions payable" are all made within a single taxable year of the beneficiary, and (b) the distributions are on account of the employee's death, whether before or after his separation from the service of the employer. "Total distributions payable" means the balance of the deceased employee's credit which becomes payable because of his death.

When distributions qualify for capital gain treatment, gain is realized on the excess of the payments over the decedent's contributions, if any. All or part of this gain may be excluded under the $5,000 exclusion from gross income of amounts paid to an employee's beneficiaries or estate on account of his death under Section 101(b).

The decedent's contributions are determined under special rules. The contribution, for this purpose, must be reduced by any amounts previously distributed to the decedent which were not includible in gross income.

If the payments to the beneficiary do not qualify as capital gains, the payments are taxable under the annuity rule of Section 72, except that the three-year income-spreading provisions of Section 72e)(3) do not apply.[1] Generally, a beneficiary receiving a lump-sum distribution will be accorded capital gains treatment, so that Section 72 would not be applicable. Denial of Section 72(e)(3) treatment would occur where a beneficiary, having received annuity payments after the employee's death, subsequently elected to take the commuted value of the annuity.

Whether capital gain treatment is allowed or not, if the distribution includes securities of the employer corporation, the amount distributed is not deemed to include any net unrealized appreciation in these securities. Appropriate adjustment to the basis of the securities is then required.

If the "total distributions payable" to a beneficiary of a deceased employee are paid to him within a single taxable year by a qualified employee's trust or qualified annuity plan, the distribution qualifies for the $5,000 exclusion from gross income of amounts paid to an employee's beneficiaries or estate on account of his death. The $5,000 is the maximum excludable for aggregate death benefits paid by reason of the employee's death. Where death benefits are paid to several beneficiaries, the exclusion must be allocated.

Where the distributions from a qualified plan are not made within a single taxable year of a beneficiary, the $5,000 exclusion applies only if the employee did not have, immediately before his death, a nonforfeitable right to the payments while living. In the case of annuities (other than joint and survivor annuities) the exclusion is applied indirectly by adding the exclusion amount to the cost of the annuity for purposes of applying the annuity formula of Section 72.

Where the beneficiary receives an annuity under a joint and survivor annuity contract, no exclusion is allowed if the starting date of the annuity occurred before the death of the primary annuitant (the deceased employee). If the annuity starting date occurs after the death of the employee, the rules relating to lump-sum settlements apply.

If the payment to a beneficiary constitutes income in respect of the deceased employee, a deduction is allowed for that portion of the estate tax attributable to inclusion of the right to such income in the decedent's gross estate. In

[1] Section 72(n)(3) provides that a lump-sum payment under an annuity control shall bear no greater tax than if received over the years.

the case of a joint and survivor annuity, the annuity received by the survivor is deemed to be income in respect of the decedent if the employee died after December 31, 1953, and after the starting date of the annuity. However, in the case of decedents dying after December 31, 1953, the question of income in respect of a decedent may be generally immaterial with regard to payments under qualified plans since the value of the right to the payments is in most cases not includible in the decedent's gross estate.

Estate tax—qualified annuity

The estate tax treatment of payments under a qualified trust as set out above is also applicable to payments under an annuity purchased directly by the employer, provided (1) the payment is made under a "retirement annuity contract," and (b) the contract was purchased by the employer under an annuity plan which qualified under Section 401(a)(3) at the earlier of either (i) the decedent's separation from employment (whether by death or otherwise), or (ii) the termination of the plan.

Income tax—qualified annuity

Rules similar to those relating to qualified employee's trusts apply to payments under qualified annuity plans. For capital gain treatment to apply: (a) the payments must be made under an annuity plan which satisfied the requirements of Section 401; (b) the annuity plan must require that any refunds of contributions be applied to reduce future premiums; and (c) the total amounts payable by reason of the deceased employee's death must be paid to the beneficiary within a single taxable year of the beneficiary.

Estate tax—nonqualified plan

Payments to any beneficiary under a nonqualified employees' plan are includible in the deceased employee's gross estate under the general rule which makes includible in the decedent's gross estate the value of any payment which the beneficiary receives, by reason of surviving the decedent, under a contract or agreement in which decedent had a right to receive payment, for the decedent's life, for any period which could not be ascertained without reference to his death, or which did not in fact end before his death.

This rule does not apply to life-insurance policies on the life of the decedent, and annuities or other payments under contracts or agreements entered into on or before March 3, 1931.

Only that portion of the value of the payments (at date of death) is includible in the decedent's gross estate which is attributable to the portion of the purchase price contributed by the decedent. Contributions by the decedent's employer are deemed made by the decedent if the contribution was made by reason of the decedent's employment. The presumption as to amounts contributed by an employer extends to any payments made by an employer to induce employment or the continuance of employment (other than payments under qualified plans).

When the amount includible in the decedent's gross estate is a joint and survivor annuity payable to the employee's spouse, the amount includible qualifies for the marital deduction if no interest in the contract passes to anyone other than the spouse.

For example, if prior to decedent's death his employer agreed to pay to the decedent's widow or other named beneficiary the balance due decedent under a deferred-compensation contract, the present value of the right to receive this payment is includible in the decedent's gross estate. If the decedent's employer voluntarily paid to decedent's widow his salary for two years following his death and was not under obligation either express or implied, because of a prior course of conduct, to make the payment, the value of the right to receive the salary is not includible in the decedent's gross estate.

Income tax—nonqualified plans

Distributions to beneficiaries of a deceased employee, made by a nonqualified employee's plan, are taxable under the annuity rule of Section 72, except that the three-year income-spreading provisions for lump-sum payments contained in Section 72(e)(3) do not apply.

Payments to beneficiaries of a deceased employee, made under a nonqualified plan, are eligible for the aggregate $5,000 exclusion from gross income of amounts paid to an employee's beneficiaries or estate on account of his death, provided that the employee, immediately before his death, did not have a nonforfeitable right to the payments while living.

If the employee possessed a nonforfeitable right to a lesser amount, the excess of the value of the payments over the value of the employee's nonforfeitable right will qualify for the $5,000 exclusion. For example, if the widow of an employee who dies before retirement may elect to take an annuity which has a greater value than the lump sum to which the employee had a nonforfeitable right, the excess of the value of the annuity over the lump sum will qualify for the $5,000 exclusion. In the case of annuities (other than joint and survivor annuities), the exclusion is applied indirectly by adding the exclusion amount to the cost of the annuity for purposes of applying the annuity formula of Section 72.

Where the beneficiary receives an annuity under a joint and survivor annuity contract, no exclusion is allowed if the starting date of the annuity occurred before the death of the employee. If the starting date of the annuity occurred after the death of the employee, the rules stated in the preceding paragraph apply.

Income in respect of a decedent

If the payment to a beneficiary constitutes income in respect of the deceased employee, a deduction is allowed for that portion of the estate tax which is attributable to the inclusion of the right to such income in the decedent's gross estate. Ordinarily, payments constituting income in respect of a deceased employee are amounts which would have been received by the decedent if he had lived. For example, a bonus earned by the decedent prior to death but not fixed in amount until after his death was held to be income in respect of the decedent when paid to his estate. But where the payment to the deceased employee's widow was made without obligation on the part of employer, the payment was held to be a gift and not income in respect of the decedent. Where the payment is in the form of a joint and survivor annuity, the income is deemed to be income in respect of the decedent if the employee died after December 31, 1953, and after the annuity starting date.

The survivor annuitant under a joint and survivor annuity does not receive the date-of-death value of the annuity as her cost basis. The annuity is taxable under the annuity rules which take into account the survivor's life expectancy in determining the expected return under the contract. The estate tax attributable to the inclusion of the annuity in the gross estate may be deducted. ☆

New trusts & estates decisions

Pecuniary legatees not taxable on "interest" in excess of estate income. Ohio law provides that pecuniary legatees are entitled to interest on their legacies until paid. Taxpayers, legatees of an estate, received in 1947 $189,000 as such interest in a year the estate had some $21,000 of income. They argued that only the $21,000 was taxable to them as income distributed. The Commissioner argued that the whole $189,000 was interest, taxable to the recipients and deductible by the estate. The court holds the payments were not true interest. They were either a statutory augmentation of the legacy and wholly nontaxable or a distribution from accumulated income, taxable to the extent of income of the year. The court concludes therefore that taxpayers in any event are entitled to be taxed as they asked. *Davidson,* Ct. Cls., 3/6/57.

Widow can amortize husband's cost of purchased renewal commissions against income [*Acquiescence*]. Taxpayer, the widow of an insurance man, received renewal commissions on insurance sold by her husband prior to his death, and similar renewal commissions that had been assigned to him (he "purchased" the renewals from other agents). The Tax Court held that collections are income in respect of a decedent under Section 126 of the 1939 Code. The court permitted her to amortize part of her husband's cost of the agency and renewal commission contracts against the income received therefrom even though the court admitted there was no mathematically accurate basis for computation of such allowances. (One dissent on the ground that costs and periods necessary for amortization were not shown.) The Commissioner announces acquiescence in the result only. While disagreeing with the treatment by the court, he will not file an appeal. *Latendresse,* 26 TC 318, *acq.* IRB 1956-8.

Grantor taxed on trust income to extent of returned charge. In 1948, taxpayer and her husband purchased business real estate for about $360,000. Some two months later each created a trust for their son to which each transferred his whole half-interest, subject to a charged reserve of $150,000. The court holds that each taxpayer is taxable on 83⅓% (150/180) of the income of the trust. [The court does not set forth the reason for its holding; apparently, the grantor is taxable because she retained an interest in the corpus. *Ed.*] *Barker,* DC Ala., 12/28/56.

Fixed payments from trust are income. Pursuant to an antenuptial agreement, taxpayer received $6,000 a year from a trust created from her husband's estate. The court holds that this payment, being recurrent, is treated as made out of income to the extent of income. On the same reasoning, the Tax Court held that these identical payments are deductible by the trust. *Somers,* DC Ohio, 10/23/56.

New estate & gift decisions this month

Widower's elective share under Ohio law computed after death taxes. A surviving husband rencounced the will and elected his statutory one-half share under the Ohio law of descent and distribution. Taxpayer-estate argued that the share going to the husband should not be reduced by any Federal estate tax. Noting the conflict in Ohio cases on whether a surviving spouse's share, eligible for marital deduction, should bear Federal tax, and turning to the latest decision of the Ohio Supreme Court, the Tax Court holds that the statutory share is computed after deducting Federal estate tax from the value of the estate. This computation of the value passing to the husband under Ohio law determines the marital deduction allowable. *Jaeger Estate,* 27 TC No. 105, 2/27/57.

Trust included in estate; decedent had power to apply corpus to beneficiaries. In 1930, decedent created an irrevocable trust for the benefit of her three children. As trustee, she reserved the power to invade corpus for the benefit of any beneficiary in her sole discretion. Further, the trust could be terminated at the request of two of the three beneficiaries with decedent's assent. The court holds that these two powers—invasion of corpus and assent to early termination—were powers to "alter, amend or revoke" the trust, and that they necessitated inclusion of the entire corpus in her gross estate. The includible amount is not to be reduced by the value of the beneficiaries' life interests since these interests were defeasible. *Grossman Estate,* 27 TC No. 80.

No marital deduction for interest retained by widow after settlement of will contest. Decedent bequeathed the residue of his estate to his second wife, and his children contemplated a will contest. In settlement of the threatened contest, the widow agreed not to dispose of any property except as necessary for her maintenance, and to make a will leaving the property to the children. The court upholds the Regulations which provide that property surrendered by a widow in settlement of a controversy is not treated as property having come to her and is therefore ineligible for the marital deduction. Turning therefore to the property retained, the court finds that the interest remaining was substantially equivalent to a life estate. It therefore cannot qualify for the marital deduction. *Tebb Estate,* 27 TC No. 76.

Bequest to sportsman's club not deductible; exempt purpose not predominant. The North Shore Sportsman's Club is a group organized by Chicago hunting and fishing enthusiasts to encourage and promote outdoor activities and to aid in the conservation of wild life. Some of its activities include classes on training of hunting dogs, demonstrations of the safe use of firearms, and lectures on prevention of stream pollution and on other conservation techniques. While conservation of natural resources might be an exempt purpose, the other activities of the club were primarily for the recreation of the members. Accordingly, decedent's bequest to the club does not qualify for the deduction for charitable, scientific and literary bequests. *Clarke Estate, (Greiss, Ex'r.)* DC Ill., 12/4/56.

Executor's commissions based on income are deductible [*Acquiescence*]. Alabama statutes base executors' commissions on both assets received and paid out and income received during admin-

Notes on new estate and gift decisions in this department are by Theodore Berger, LL.B., CPA, who practices in Chicago.

istration. The Commissioner argued that only commissions based on principal were deductible for estate tax. The Tax Court allowed the entire amount as expense of administering the estate. The estate was not engaged in business; the commissions therefore cannot be regarded as a cost of earning income and deductible for income tax only. *Hubbard Estate,* 26 TC No. 19, *acq.* IRB 1957-6.

Executor's commission deductible though in excess of statutory rate [*Acquiescence*]. Pursuant to the directions contained in a letter from the decedent, the estate paid the executor a 5% commission, which is in excess of the usual rate. The Orphan's Court of Pennsylvania authorized the payment, but for unexplained reasons only about half of this amount was allowed in computing the Pennsylvania inheritance tax. Nevertheless, this court allowed the full amount authorized and paid as a Federal estate tax deduction.

A deduction was also allowed for the full amount of a bequest in trust for the care of a family plot in a church cemetery: part of the bequest was a funeral expense and part a contribution to a religious organization. Finally, the court allowed a bequest in trust to the Philadelphia Bar Association for the preservation of books in its law library. While the library was used by practicing lawyers, it also served a public purpose and aided scholarship. *Audenreid Estate,* 26 TC No. 12, *acq.* IRB 1957-1.

Resignation as trustee at age 87 was not relinquishment of powers in contemplation of death. In 1934, decedent created a trust of which he was co-trustee. The trustees had the discretion to invade corpus for the benefit of the income beneficiary, decedent's daughter. In 1946, decedent resigned as trustee. He was then 87 years old and in good health except for his failing eyesight. He died less than a year later after a brief illness. Noting that the corpus of this trust repreesented only $150,000 and that decedent's gross assets were more than $1,000,000, the court finds that the saving of estate taxes did not prompt the relinquishment of the powers and that the relinquishment was not made in contemplation of death. *Langshaw Estate, Duncan, Ex'r,* DC Mass., 2/6/57.

Commuted value of dower qualifies for marital deduction. Common-law dower is only a life interest in a portion of the husband's realty to which the widow is entitled. But under the Missouri statutes a widow has the election to take the commuted value of this interest in cash, the commuted value to be based on actuarial tables. The court holds the right to take commuted value is a separate interest which passes to the widow and qualifies for the marital deduction. It is not the conversion by the widow of a nonqualifying life estate into cash.

The property which passed to the widow was a portion of the net estate after payment of estate tax. Missouri has no statute on the subject. Therefore the court applies the doctrine of equitable contribution. And since she received 37% of the gross estate, 37% of the estate tax is charged against her share in computing the marital deduction. [The court does not discuss the theory accepted in some jurisdictions that since the share is deducted as a marital deduction no estate tax should be charged. *Ed.*] *Miller Estate, Traders Nat'l Bank, Exr.,* DC Mo., 12/18/56.

Grantor as co-trustee could determine income distributions; trust property part of his estate. Decedent's wife created a trust in 1938 to which decedent made additions in later years. Decedent and their son were co-trustees, and as such had discretion to distribute income to the son or to accumulate it. Although decedent was in fact not active in the trust administration and it was unlikely in the circumstances that he would exercise his power against his son's wishes, the court holds that the possession of the power results in the inclusion in his estate of the portion of the trust attributable to his own contributions. *Biscoe Estate,* DC Mass., 1/30/57.

Proceeds of aircraft-owner's liability insurance not includible in gross estate. Decedent was killed in an airplane accident. The owner of the plane had taken out a policy under which a fixed sum was payable to the estate of any passenger killed. Payment was conditioned on the estate's releasing the owner from further claims. The Service holds that although payment to decedent's estate was made without proof of the owner's legal liability, it was intended as damages and not as insurance. Not being insurance, it is not includible in decedent's gross estate. It would be so includible if the release were not a condition to payment; in that case it would be insurance, not damages. *Rev. Rul.* 57-54.

Property transferred with retained interest not includible; was for consideration. Decedent's father's will gave her the right to build a home on a plot of ground she selected and on her own death to have his executors pay her estate the fair value of the house. Decedent entered into an agreement with all interested parties waiving this provision and taking instead a life estate in a specific parcel of realty, with power to dispose of it and retain the proceeds. This agreement was held by the district court to be a gratuitous transfer intended to take effect at decedent's death. This court reverses; the agreement was made for a bona fide consideration. *Ricketson Estate, Peoples First Nat. Bank, Ex'r,* CA-3, 2/14/57.

Estate tax refund for legal fees re tax claim not subject to three-years-after-payment rule. The Code limits tax that can be refunded to the amount paid within three years prior to filing the claim. The Commissioner argued that this prevents refund arising out of the legal expense incurred in obtaining complete refund of a deficiency assessment. In this case, the original tax had been paid more than three years before filing for refund of the additional assessment. The court concludes this result was not intended, and it allows a refund based on deduction of attorneys' fees. *Langshaw Estate, Duncan Ex'r,* DC Mass., 2/6/57.

No marital deduction for legal life estate despite power to invade. Decedent bequeathed $217,000 of securities to his widow for life, with unlimited powers in the widow to invade principal during her lifetime; any balance of principal remaining at her death went to certain named legatees. The executors argued that the unlimited power of invasion was the equivalent of absolute ownership under applicable New York law, or alternatively that the life estate with invasion powers was similar to a marital-deduction trust—a trust in which the widow has life income and an unrestricted power of appointment. This court, with one dissent, construes the marital-deduction provisions strictly. It limits the deduction to outright bequests or actual trusts meeting all specified statutory requirements. *Pipe Estate,* CA-2, 2/7/57.

Widow's interest in portion of trust does not qualify for marital deduction. [*Certiorari denied*]. Decedent's will left his residuary estate in trust, two-thirds of the trust income being payable to the widow for life. A codicil to the will gave the wife a general power of appointment over one-half the trust corpus. Although the widow exercised this power about a year after decedent's death, the circuit court held that the interest was terminable at date of death. Although she had a power of appointment, there was no certainty she would exercise it, and except for the power she had merely a life income. Further, the interest did not qualify under the exception for certain powers of appointment because the widow's right to income and power to appoint did not extend to the entire trust corpus. [The 1954 Code permits a marital deduction where the widow is entitled to all of the income for life from a specific portion of the trust with a power to appoint such specific portion. *Ed.*] *Shedd Estate, cert. den.*, 3/4/57.

Lawyer's estate includes right to post-death earnings of partnership. Decedent was a member of a law partnership. The partnership agreement provided that a deceased partner's estate would share in the partnership earnings for a specified period after death. The firm had no material tangible assets, and decedent had made no contribution to capital. The court holds that the value of the right to share in earnings is an asset of the estate includible for estate tax purposes. The court distinguishes *Bull* (295 U.S. 247), where an accountant's somewhat similar rights were excluded from his taxable estate. There Bull's estate had the right to elect not to continue and if it did it would share losses. The Supreme Court refused to allow any value on "the mere right of continuance." The Tax Court points out that here there was no option to withdraw and no provision that the estate would have to share losses. [The 1954 Code provides specific rules for taxation of distributions to a deceased partner. *Ed.*] *Riegelman Estate*, 27 TC No. 101, 2/25/57.

Gross estate includes property appointed to takers in default. Decedent's mother created a trust in which decedent had a life interest with a power to appoint the corpus. Remainder was to go to decedent's children if she failed to exercise the power. Decedent's will gave the residue of her estate, including any property subject "to my power of appointment" to her daughters. An appropriate Pennsylvania court ruled that the daughters would have taken anyway. But this court holds that that decision was not binding for Federal estate tax purposes. Under tax law, appointment to takers in default is exercise; it follows that the property subject to the power is part of decedent's gross estate. [Property subject to a power created after 1942 is includible whether or not exercised. *Ed.*] *Maule Estate, Thompson, Ex'r*, DC Pa., 2/14/57.

Widow's agreement to take weekly sum from testamentary trust a terminable interest. Decedent bequeathed his widow a life estate in two pieces of real property and named her as one of the beneficiaries of a trust. However the trustees were given absolute discretion as to the amounts of principal and income to be distributed and the beneficiaries to whom to pay it. She entered into an agreement with the trustees to accept $50 a week for life. On appeal, the court affirms without opinion the Tax Court holding that the agreement was not a renunciation of the will and an election to take dower; nor was it a purchase by the trustees of her dower rights. The payments she was to receive were in effect provided by the decedent's will: the trustees merely agreed to exercise their discretion in this way. Her interest was therefore only for life and as such terminable and not includible for the marital deduction. *Kleinman*, CA-6, 2/20/57.

No refund under Technical Changes Act for compromise settlement of reverter and other issues. In *Spiegel* (335 U.S. 632), the Supreme Court required inclusion in the gross estate of certain lifetime transfers in which the decedent retained a reversion, no matter how remote. To relieve the harshness of this decision, Congress permitted, in Section 7 of the Technical Changes Act of 1949, refunds of tax paid because of a remote reversionary interest. The taxpayer-estate had a case before the Tax Court at the time of the *Spiegel* case in which the Commissioner asserted tax on the property transferred because (1) a reversion was retained and (2) the transfer was in contemplation of death. The case was settled by a stipulation that $20,000 was owing; no grounds for the deficiency were stated in the settlement. The taxpayer here sued for refund of that deficiency. The court denies it. The taxpayer may have settled the earlier case it had doubts of winning on the reverter issue. However, it has not shown how much it paid because of the existence of the reverter. Accordingly, it is not entitled to the special relief provided by the Technical Changes Act. *Roberts Estate*, Ct. Cls., 3/6/57.

Trusts for minors are future interests (old law). Taxpayer created separate trusts for each of his five minor grandchildren, the trusts to terminate as each reached 21. The income was to be paid currently for their support, and trustees had discretionary power to invade corpus for their benefit. Since the beneficiary or his guardian did not have the unqualified right to demand corpus at any time, the court holds the trusts created future interests and under the 1939 Code the donor is not entitled to the $3,000 annual gift tax exclusion. [The question of whether the beneficiaries' interest in income was a present interest was not raised. *Ed.*] *Katz*, 27 TC No. 95, 2/14/57.

Power to accumulate income for beneficiaries makes gift future interest. Taxpayer created two separate trusts for the benefit of each of her twin granddaughters, age 16 at the time the trusts were created. The trustee was to pay out of income for their educations and to accumulate the balance of income. At 21 the girls could call down the accumulated income. Thereafter the income would be paid currently for life. Since the beneficiaries had no right to receive all the income until their 21st birthday, the gifts were gifts of future interests; the $3,000 annual exclusion is not allowable. *Crane*, TCM 1/9/57.

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Rapid depreciation in real-estate deals may founder on tax trap in Regulations

REAL ESTATE deals these days are tailored to take advantage of the new accelerated depreciation provisions of the 1954 Code. The lower taxes in the opening years of operation serve as an interest-free loan from the U. S. Treasury, and the developer needs less cash of his own. But whether this kind of deal will stand up is questioned by C. L. Kelly, CPA of Eugene, Oregon. The Commissioner might, Mr. Kelly suggests, use the new Regulations to rule that much of the gain on sale of property so depreciated would be ordinary, not capital.

Mr. Kelly, who was formerly a partner in Kelly, Kohnen & Co., CPAs, is professor emeritus at the University of Oregon. He explored this question in a paper written for the recent Oregon Tax Conference. Describing the position of the mythical developer who knows the tax angles, he points out the difficulty likely to arise under the new Regulations, especially where the developer decides to sell for a substantial book capital gain. Here is how Mr. Kelly put it:

Developer buys supermarket

Suppose Mr. Smith owns a tract of land worth about $150,000. He decides to build a supermarket at a cost of $400,000 and finds that he has to borrow $350,000 on a 12½ years' basis at 5% per annum. Roughly, annual service charges on the loan will be $36,750. Since there would also be taxes and other fixed annual expenses of $15,000, his annual cash outlay would be around $51,750. If the rentals are adjusted to amortize the cost of $550,000 over 12½ years or a minimum of $44,000 per year, Mr. Smith will still be cash out-of-pocket by $7,750 per year before income taxes. After three of four years perhaps, the percentage clauses on the leases would begin to bring in additional rentals of more than enough to close the gap between cash outgo and income. In the meantime, Mr. Smith must meet the cash deficit from other funds.

What advantages will Mr. Smith obtain by using an accelerated method instead of the straight-line method?

When he estimates the useful life of the improvements at 25 years with no salvage value, he obtains the figures in the accompanying table.

Year	Straight Line	200% on Declining Balance	Years' Digits
1	$16,000	$ 32,000	$ 30,769
2	16,000	29,440	29,538
3	16,000	27,085	28,308
4	16,000	24,918	27,077
5	16,000	22,925	25,846
Total first five years	$80,000	$136,368	$141,538
6	16,000	21,091	24,615
7	16,000	19,403	23,385
8	16,000	17,851	22,154
9	16,000	16,423	20,923
10	16,000	11,804[1]	19,692
11	16,000	11,804	18,462
12	16,000	11,804	17,231
13	16,000	11,804	16,000

[1] Change to straight line here.

Although as we figured it above, Mr. Smith would be cash out-of-pocket of about $7,750 for the first few years, he would not fare so badly. He would have a loss on rental for the first year which he could apply against his other income. The loss would be computed by deducting from the $44,000 rental income the following: depreciation, $32,000; taxes and insurance, $15,000; and interest, $17,000. The deductions total $64,000, $20,000 more than the income.

If Mr. Smith used straight-line depreciation, his depreciation would be only $16,000 and he would have a loss of only $4,000 to apply against other income for income tax purposes. But if he used the declining-balance method, he would effect substantial income tax savings, perhaps as much as $8,000. At any rate, the saving on income taxes would approximately offset the cash out-of-pocket difference between the rental and the servicing of the loan.

Assuming that income tax rates remain the same in the future and assuming that the supermarket is successful in its operation, it is obvious that there will be approximately the same amount of depreciation taken by any method over a 25 years' life; if annual income is relatively stable, the total amount of income taxes paid will not vary greatly when computed on the three methods of depreciation. However, the economic gain is substantial if an accelerated method is used. Mr. Smith would have the use of about $8,000 (the saving on income taxes the first year) for several years. If short-term money is worth 6% per annum, that is worth $480 a year to him. This is based on simple interest alone. Though the savings on income taxes in the successive years will be in decreasing amounts, a substantial sum will be saved for the first nine years. These are the crucial years for Mr. Smith. By the end of nine years, if the supermarket is successful, the mortgage will be substantially liquidated.

Suppose, however, that, after four or five years or so, the supermarket should fail, or that the income should decline. In that case, Mr. Smith would have an economic gain of all or substantially all of the saving of income taxes for those years. Perhaps, as much as $30,000 to $40,000. To some extent Mr. Smith, by selecting an accelerated method of depreciation, has shifted some of the risk involved in the success of the supermarket to Uncle Sam. Perhaps, this should be stated in another way: Congress, in the revision of the 1954 income tax laws, encouraged taxpayers to shift a part of their risk of success (or failure) to Uncle Sam.

When taxpayers assume that income tax rates will remain approximately the same for the long-run future and base their calculations on that assumption, they are gambling against higher tax rates. The late Col. Robert H. Montgomery made a calculation in the 1930's, wherein he estimated that the over-depreciation taken by taxpayers during the years prior to his calculation was costing taxpayers millions of dollars per year at that time. Taxpayers had assumed that "a bird in the hand is worth

two in the bush." They had depreciated their tangible assets to salvage or even zero when the rates were relatively low and were consequently hit very hard when the rates were greatly increased. The writer is not a pessimist; however, accountants should be realistic about tax problems. Sometimes and under some circumstances, perhaps, it is unwise to encourage deferring of income taxes.

Results under years' digits method

Suppose that Mr. Smith selects the years'-digits method of depreciation for 13 years. His allowable depreciation would be $304,000 on a cost of $400,000, in contrast to a depreciation of $208,000 by the straight-line method. To keep the example as simple as possible, assume that the supermarket is going along in a normal manner, that the growth of the market area is normal and that the future of the area is normal. Assume that a syndicate approaches Mr. Smith with a plan to purchase the entire property and that Mr. Smith is interested in selling.

The land is now worth $175,000, and the replacement cost less straight-line depreciation is $231,000. Both amounts total $406,000, which is $160,000 more than present book value of $246,000.

Could Mr. Smith, under the 1954 Code treat the $160,000 as capital gain? If so, would it be advisable to sell at the price of $406,000? If Mr. Smith continues ownership of the supermarket, his total deductions for depreciation for the next twelve years will be only $96,000. The net rental income will be ordinary income for income tax purposes. The income taxes for the next twelve years are sure to be more than $40,000 (25% of $160,000). Based on these figures, Mr. Smith has real capital gains of $63,400 ($25,000 on the land and $38,400 on the building). The $38,400 is computed by assuming that it would cost $80,000 more to replace the building at the end of the first 13 years' life than it originally cost. In the Regulations relating to salvage, we find: "Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or disposition of an asset which is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer." The Regulations add: "The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage may represent a relatively large proportion of the original basis of the asset. . . . *Salvage value must be taken into account* in determining the depreciation deduction. . . ."

Exactly what the interpretation of the law and the Regulations will be in a case like Mr. Smith's is not known. In general, it would appear that the Commissioner might contend that a substantial part of Mr. Smith's gain on the sale of the supermarket would be ordinary income and only the actual capital gain would receive capital gain treatment. Presumably the Commissioner would agree that Mr. Smith's policy was to dispose of the supermarket while it is in good operating condition. In such a case, the salvage value would be high and far too much depreciation had been charged to income.

If the Regulations mean what they say, the Commissioner can be expected to scrutinize all so-called capital gains on assets which have been subjected to some method of accelerated depreciation. ☆

New Section 177 aids trademark owners, but buyers don't get any help

by **ADRIAN A. KRAGEN**

When Congress enacted Section 177 into the Code last year, it provided a real tax benefit for the small corporation owning trademarks or tradenames. It can now expense, rather than capitalize, some of the costs of producing and protecting that mark. The purchaser of the trademark, on the other hand, can do no such thing. Section 177 specifically excludes such expensing. Since many problems result from this dichotomy, the author here searches the background, analyzes the effect of the new section, and shows some of the ways to build up costs. A portion of this article originally appeared in the California Law Review. Mr. Kragen is Professor of Law, University of California, Berkeley.

THE ENACTMENT of Section 177[1] of the Internal Revenue Code has opened substantial opportunities for any individual who handles trademark problems. Effective June 29, 1956, the section had a somewhat curious purpose. According to the committee report on Public Law 629 which included Section 177, small corporations had been forced to capitalize such expenditures as legal fees incurred in the production of trademarks and tradenames, but large corporations, because they use their own employees to handle these matters were able, (illegally, it was implied) to throw the costs into their general expenses and make them impossible of identification by the revenue agent. The committee therefore enacted the section to aid small companies whose transactions were not large enough so that they could adequately conceal them from the scrutiny of the revenue agent. This very peculiar reasoning, which it is conceded is not as brusquely spelled out in the committee report, is a poor reason for a change in our revenue laws. However, there was and is substantial reason for allowing some type of expensing or amortizing of the cost of trademarks and tradenames.

Section 177 takes a few steps forward in this regard. But it still leaves a very substantial inequity between the tax treatment of the created and retained mark as compared with the purchased mark.

Effect of the new provisions

One very helpful provision of the new section allows for an individual election by the taxpayer for each mark. A taxpayer may now elect to use a 60-month amortization for one mark and a 120-month amortization for another. This allowance may well make the election much more valuable.

The section is certainly going to make the manager of the trademark department hesitate much more on the purchase of a mark and will greatly encourage organizations to develop their own marks.

It also may well encourage more litigation over trademarks and tradenames

because the section applies to the expenses (which otherwise would be capital in nature) involved in the defense of a trademark or tradename. In a case[2] which arose before Section 177 was enacted, the Tax Court held that expenses of litigation must be capitalized. That holding has naturally deterred litigation on trademark infringements. Although amortization over a period of five years or more (as permitted by Section 177) is hardly adequate, it is substantially more beneficial than the requirement of the *Food Fair* case[3] that such expenses be capitalized.

There would appear to be no question that defense as used in Section 177 applies to affirmative actions to protect a trademark as well to defense of actions brought by others. Thus it may well be that the opportunity to let the Federal Government bear 52% or more of the cost of the litigation may induce trademark owners to adopt a more aggressive attitude. There is much more that can and should be done to provide equitable tax treatment in this area, but Section 177 is at least a progressive step in the direction of uniformity of treatment for the trademark.

Practitioners faced with trademark or tradename problems will be glad to be able to fit under Section 177 those costs which under prior law had to be capitalized. But they will continue to strive to expense as large a part of the costs as possible.

Build up costs

Consideration must be given to the constant "vitamin injections" necessary for every trademark, i.e., those expenditures which can be characterized as build-up costs. Jones chooses the name "San Francisco's Better Batter" for his prepared cookie mix. He expends a large sum making that delectable-sounding name known throughout the western United States through newspaper, magazine, radio and television advertising. The expenditures are necessarily for the dual purpose of promoting the present sale of the product and building protectibility. Should these expenditures be regarded as capital or current expense?

Would the Commissioner be justified in taking the position that they can be likened to those of the property owner who builds a building on a vacant lot? The Regulations provide that expenditures which improve the property and lengthen its life or expand its usefulness must be capitalized in the case of tangible property. If Jones neglects to make expenditures of this nature, Jones' tradename, however exotic, will soon disappear from the business world. Although the process of extinction may be slower, the same result would occur in the case of Coca Cola, Cadillac or Ethyl.

The Commissioner and the taxpayer have, in a handful of reported cases, attempted either to obtain allocation of advertising expenses between current expense and capital cost or to attribute the entire amount to one or the other. Naturally, the positions of the parties have not been consistent, each urging the result which would, for the moment, give the most advantageous tax result. The courts, viewing the opposing contentions, have generally held that the task of allocating between current business expense and capital cost of building future values is too difficult and that, absent clear and convincing evidence of the latter, all proper advertising expenditures should be considered an item of current expense. Illustrative of this approach is the decision of the Sixth Circuit in *Sheldon & Co. v. Commissioner.*[4] The company was engaged in the laboratory equipment business, and as a sales device periodically issued catalogs. In 1946, it issued a catalog; the next catalog was being prepared in 1952 when the case was first heard. The question for the court was the deductibility in 1946 of the cost of the catalog which would be effective for more than a year. The circuit court stated that "the fact that an expenditure produces something that has a useful life extending beyond the taxable year is not the controlling test." Following other decisions, it held that advertising expense, even though incurred heavily in one year with resulting benefits in future years, was nevertheless a deductible expense for the year in which expended. However, in a few cases involving extraordinary expenditures or a particular accounting segregation, the courts have allocated a portion of the advertising expense to the acquisition of a nondepreciable intangible.

Purchased marks

Our friend Jones, the cookie batter king, creates in his mind a trademark, converts the idea to concrete form and spends a million dollars advertising that mark. As indicated above, the entire amount will undoubtedly be currently expensed without question or comment. However, if Jones found instead that he could acquire for a million dollars an already established trademark suitable for his purposes, a mark which would obtain the same market for his product without any additional expenditure, he would not be allowed to expense any portion of the million. Section 177 specifically excludes purchased marks so that the item of expenditure would be unusable for tax purposes so long as he kept the mark, for he would be held to have acquired a capital asset and a nondepreciable one at that. Thus, the fact that in each instance a million dollars was spent to achieve an identical result will not serve to bring about an identical tax consequence. By some critics of our tax laws this may be considered as another instance in the tax law administration where form triumphs over substance. Of course, the purchased mark will have a million-dollar basis for tax purposes upon sale, but that is small solace to the purchaser whose intent is to use it in perpetuity when he endeavors to set off its cost against the income which he hopes its million-dollar value will bring him.

There is another problem in relation to the purchase of trademarks which should be mentioned briefly. This problem arises where there is a purchase of a business whose assets include, among other items, trademarks. Of course, for the purpose of the ultimate tax consequences, the purchaser will normally use whatever leverage he can to attri-

[1] Section 177 reads as follows:
(a) Any trademark or tradename expenditure paid or incurred during a taxable year beginning after December 31, 1955, may, at the election of the taxpayer . . . be treated as a deferred expense. In computing taxable income, all expenditures paid or incurred during the taxable year which are so treated shall be allowed as a deduction ratably over such period of not less than 60 months (beginning with the first month in such taxable year) as may be selected by the taxpayer in making such election. The expenditures so treated are expenditures properly chargeable to capital account for purposes of Section 1016 (a) (1) (relating to adjustments to basis of property).

tax problems?

For the quick answer to *all* Federal tax questions, keep Alexander's Federal Tax Handbook, 1957 Edition, on your desk at all times. See back cover for order blank.

bute the maximum value to the depreciable assets and the smallest portion possible to trademarks, goodwill and other nondepreciable properties. Although the Service generally accepts the arms'-length valuations of the parties, it will not approve valuations which cannot be substantiated by the facts and which are premised primarily on tax considerations. However, even where the amounts which the negotiators could have designated would have been reasonable, there have been a number of instances where the parties simply ignored any dollar segregation and in the sale agreement priced goodwill at a lump sum without particular value reference to the separate intangibles acquired in the transaction. This failure must have occurred either because of ignorance on the part of the representative of the purchaser, or because it was anticipated that the trademark and the total goodwill were inseparable *in toto*. However, we are all aware that in many cases subsequent transactions occur in which there are transfers or dispositions, such as a right of area use of the mark together with the goodwill attached thereto, or abandonment of the mark, in which the basis of the mark, for tax purposes, is of utmost importance. In the absence of a segregation in the original purchase agreement, the court will normally examine the evidence produced, which is usually vague after the passage of a long period of time, and make its own segregation, possibly making an allocation to the retained goodwill which is far in excess of the purchaser's own concept of that value. If the purchaser is basically interested in the mark, or recognizes a value attributable to the mark, he should make the value allocation in the agreement instead of leaving it to the court to make the calculation 20 years later.

Depreciation of trademarks

With the new emphasis in the 1954 Code on accelerated depreciation and the much more tolerant attitude of the Service with respect to the taxpayer's choice of the method of depreciation, the effect of the refusal to allow any depreciation of trademarks is accentuated. The position of the Commissioner on the nondepreciable nature of the trademark is based primarily upon the decisions of the Supreme Court in *Clark v. Haberle Springs Distillery*[5] and *Renziehausen v. Lucas*.[6] The former case related to the attempt to allow for obsolescence of goodwill occasioned by the closing of the distilleries due to the advent of prohibition; the latter was concerned with the effect of the same events on goodwill including trademarks and tradenames. There is serious question of the general applicability of these cases; however, they have been cited as authority for the proposition that goodwill and trademarks are per se nondepreciable assets. There is no possibility of disagreeing with this position, if we concede that for all practical purposes trademarks and goodwill are akin to the "good earth" and are perpetual in existence.

We can admit that there is great uncertainty about the life of goodwill or a trademark, but the fact of actual indefinite existence has not been a deterrent to the allowance of depreciation of other properties. For example, a motion picture has an uncertain life, but it does have what we may call an average mortality experience which is "guessable" and on the basis of which depreciation has been and is calculated and allowed.

It would seem that the experience with trademarks is sufficient to allow for the calculation of an actuarial formula with no greater ratio of error than we have experienced in the motion-picture industry, or in fact in most other industries.

Despite the unequivocal attitude of

(b) For purposes of subsection (a), the term "trademark or tradename expenditure" means any expenditure which—
(1) is directly connected with the acquisition, protection, expansion, registration (Federal, state, or foreign), or defense of a trademark or tradename;
(2) is chargeable to capital account; and
(3) is not part of the consideration paid for a trademark, tradename, or business.

[2] Food Fair of Va., Inc., 14 TC 1089.
[3] *Ibid.*
[4] 214 F2d 655 (6th Cir. 1954).
[5] 280 U. S. 304 (1930).
[6] 280 U. S. 387 (1930).
[7] 152 F2d 570 (2d Cir. 1945).

TAXES UP — PROFITS DOWN

WE WOULDN'T want to try to make public finance experts out of our readers, but we do think an occasional short summary of who pays how much taxes on what income is useful background for any tax man. So:

Corporate income: The SEC reports third quarter (1956 compared with 1955) sales of manufacturing corporations up $5.4 billions to $74.6 billion; profit before taxes, skidded a little, to $6.7, the lowest in the last seven quarters. Profits after taxes were $3.6 billion, the lowest also in the past two years. This can be expressed in profits-after-taxes per dollar of sales of 4.9¢ in 1956, against 5.4¢ to 5.5¢ in the preceding two years.

Personal income taxes: While corporate income taxes are expected to stay about the same for 1956 and 57 (according to the new budget estimates), individual income taxes, which were $35,334 million in 1956 will rise to $38,500 million in 1957, and $41,000 million in 1958.

Tax policy: Secretary of the Treasury Humphrey, in his recent protest against increased federal spending, said:

"I think we all want—and you all want—to think as citizens. Now, what goes on is this: Our tax laws are so very high—the amounts that we take from everybody are so very high—that there is hardly anybody in this country or any group in this country that cannot come down here and show that they are hurt by the taxes they pay.

"Congress has given them some consideration. From a little tax law this thick, we have one that is as thick as this, because all sorts of gadgets and relief of various kinds have been granted to various sets of people instead of having over-all relief granted.

"Of course, there are a few strictly unfair things that creep into the law occasionally that need to be straightened out, but, if we can stop making all these little adjustments all around, except the very unfair ones, and save our money until we can make a reduction all down the line, everybody gets the benefit of that, and the pressure on everybody is taken off.

"If you take the opposite side of that, and if you go on just giving little groups here and there and everywhere special consideration and bringing them down, the first thing you know, you are going to have to raise the rates on the poor fellows who are left, and they are going to have to pay higher rates, because we have to have so many dollars to run the business with.

"Every time you give a special group relief, you are just putting that much burden on everybody else, and I think it is high time we quit burdening everybody else for special people and we should try to get everybody down all at one time." ☆

the Commissioner, it is suggested that the case law does not offer unquestioned support for his position. The *Haberle Springs* and *Renziehausen* cases arose out of the peculiar situation incident to the prohibition law. The Supreme Court decisions appear to be based entirely on this factor. When the former case was in the Second Circuit, the court recognized that, upon the evidence of limited duration, goodwill and trademarks were entitled to depreciation in the same manner as other capital assets. The Supreme Court decided its case upon the premise that "when a business is extinguished as noxious under the Constitution the owners cannot demand partial compensation in the form of abatement of taxes"; the Court did not discuss the basic language as to the nature of goodwill. Subsequently in *Williams v. McGowan*[7] one of our most able and respected jurists, Learned Hand, reaffirmed the holding of the Second Circuit in the *Haberle* case to the effect that goodwill may be a depreciable intangible.

IRS requests information to aid Bulletin "F" study

THE IRS RECENTLY announced that it would welcome information from all those interested in the forthcoming study of Bulletin "F" announced last month. The following information would be welcomed by the Advisory Group working on the study:

Information needed

1. List of depreciable items not presently included in Bulletin "F."

2. Estimated normal total useful lives by major items or classes of depreciable property. Where practicable, submit pertinent information as to factors affecting the normal useful lives recommended. (The normal total useful lives suggested should be for a normal operating schedule. Include statement of the normal operating schedule used.) This relates to items presently included in Bulletin "F" as well as to new items tax men may want to add.

3. Where average or composite lives are suggested for an account or group, it is desirable to show how the life was computed.

Suggestions and related data should be submitted in duplicate to the Commissioner of Internal Revenue, Washington 25, D. C., Attention: T:S:EA:F, not later than June 30, 1957. ☆

New accounting decisions this month

CAPITAL GAINS

Capital gain on subdivision and sale of farmland. In 1934, taxpayer, a physician, bought a farm just outside the city of Saginaw. He made improvements and operated the farm himself or through sharecroppers or tenants, but always at a loss. In 1947, after a heart attack he decided to liquidate the farm. He had the land subdivided and gave a large section for a church and a park. He did no advertising but in 1948 sold 46 lots; 1949, 6; 1950, 10. The court holds he did not hold the property for sale to customers. The gain was capital. *Berberovich*, DC Mich., 1/18/57.

Dealer has ordinary income on sale of unimproved land. Taxpayer, a real-estate dealer, sold unimproved lots which he claimed he acquired to develop and retain as a capital investment. However, since little effort was made to realize the income-producing potential, and taxpayer displayed a willingness to sell whenever an advantageous opportunity presented itself, the Tax Court ruled that the lots were held primarily for sale in the ordinary course of business. This court affirmed. *Clayton*, CA-6, 2/7/57.

Attorney had capital gain on sale of land. Taxpayer, a practicing attorney who owned no other real estate, acquired two parcels of land in 1943 to be used for agricultural purposes. In 1946, he contracted with a broker to sell subdivided lots from one of the parcels. He also sold a 60% interest in the other parcel, after which he contracted to sell this parcel too. He took no part in the actual selling. The court holds that he was not in the real-estate business and that his profits were capital gains. *Say*, DC Calif., 1/22/57.

Sale of subdivided realty capital gain. In 1948, taxpayer acquired six acres from his father. Two years later, he subdivided the land and sold one lot. The court holds that the land was a capital asset, because taxpayer presented no evidence showing that he was engaged in the real-estate business or that he had acquired the land with any intention of using it except as his residence. The fact that in 1952 taxpayer entered the real-estate business did not alter his 1950 status. *Embry*, DC Ky., 8/31/56.

Income from sale of tree stumps by investor a capital gain. Gain realized from the sale of tree stumps held by a taxpayer who is not in the timber or tree stump business, but who acquired the cutover property some years before as an investment, constitutes gain from the sale of "capital assets." *Rev. Rul.* 57-9.

Ordinary income on surplus bomb hoists. The owner of a store selling ball bearings was unable to continue payments on a purchase of some 1,500 surplus bomb hoists. Taxpayer and another metal dealer each bought a third interest, advertised the hoists, distributed printed material through their regular salesmen and otherwise, and finally sold them—mostly to a junk dealer. The Tax Court held the income ordinary—the hoists were bought for immediate resale. One judge dissented on the ground that hoist sales were not continuous enough to be a business. Petitioner's attitude was far more passive than carrying on a business. The circuit court affirms, although one judge dissents. He agrees with the minority opinion in the Tax Court. *Zack*, CA-6, 2/19/57.

Payment to cancel supply contract is ordinary income. Taxpayer, a petroleum-marketing partnership entered into an agreement with a supplier in 1948 to purchase 2,250,000 gallons of gasoline per week. Because of a shortage in the supply of gasoline, the parties agreed in 1950 to terminate the contract upon the payment by the supplier to the taxpayer of $183,000 in "cancellation" and "termination." The payment is held taxable as ordinary income, not capital gain, since one of the essential elements of a "sale or exchange," a transfer of property, was lacking. *Leh*, 27 TC No. 110.

Ordinary income on sale of used water coolers previously leased. Taxpayer leased and sold electric water, beer, and frosted-food coolers. It sold both new and used coolers from inventory; and sold some leased coolers to lessees. It conceded that its sale from inventory

resulted in ordinary income, but contended that the coolers which were leased and then sold had been "used in the business," not "held for sale," so that they were capital assets. The district court disagreed, finding that the taxpayer is in the business of both leasing and selling coolers, whichever was more advantageous, and no distinction could be made between the coolers sold from inventory and the ones sold while out on lease. The fact that rental income predominated did not alter the result, because there was no evidence that such a situation was anything but a normal characteristic of a rent-or-sell business in the particular industry. This court affirms. *SEC Corporation,* CA-2, 2/25/57.

Employer's "shop rights" in patent do not preclude capital gain on sale by employee. [*Acquiescence*]. For a royalty of 1% of sales, taxpayer, an electrical engineer, assigned to his employer his patent on a waste-disposal unit which he had developed on his own time but on company premises and with the help of two company employees. Because the patent was developed at the corporation's expense, the Commissioner asserted, the employer had such a substantial interest in the patent that the taxpayer could not have made a sale of "all substantial rights," taxable as a capital gain under the 1939 Code. The Tax Court held, however, that the employer's "shop rights" would give it merely a nonexclusive right to use the patent; this is insufficient to dilute taxpayer's substantial rights in the patent. Amounts that he received as royalty payments are taxable as capital gain and not as ordinary income. *Jordan,* 27 TC No. 27, *acq.* IRB 1956-8.

Patent agreement a license, not a sale; gain is ordinary. Taxpayer, inventor of a method for articulating sound, appointed a corporation as exclusive representative, except for the motion-picture-cartoon field, in return for an annual retainer of $12,000 and royalties on a sliding scale. The agreement was called a license, and the court holds it was not a sale. He had not made a sale of all substantial rights. The royalties were ordinary income. *Wright,* DC Cal., 1/2/57.

Note from business aide neither worthless nor deductible as a business expense. Taxpayer, who was in the business of laying pipelines underneath rivers, loaned $40,000 on a six-month 6% note to an individual who helped it procure a large contract. The note was to be repaid out of fees which the individual was expected to earn during the course of construction under the contract. Two months later, when the contract was abrogated because of the failure to get a governmental Certificate of Convenience and Necessity for the job, taxpayer deducted the $40,000 as a bad-debt loss. The court denies the loss since taxpayer offered no proof that the note became worthless at that time. It also holds the debt was a bona finds loan and could not be claimed as promotion expense. *Missouri Valley Dredging Co.,* TCM 1957-38.

Butter futures ordinary loss to cheese dealer [*Acquiescence*]. The court allowed a loss on closing out butter futures contracts in full as a hedging transaction. If found that the futures were sold to protect taxpayer, a cheese and egg wholesaler, against his cheese commitments. *Kurtin,* 26 TC No. 121, *acq.* IRB 1957-2.

Collections on "flat" bonds capital. Rev. Rul. 55-423 invalid. In 1942, taxpayer purchased certain bonds "flat" when interest was in default. Prior to 1950-52, the years in issue, she had received payments of the coupons equal to her basis. In accordance with *Rev. Rul.* 55-433, the Commissioner taxed the receipts after complete recovery of basis as ordinary income. In *Rev. Rul.* 55-433, the Commissioner had taken the position that if one who purchased defaulted bonds flat collects interest which is more than his basis, the excess is ordinary income if it is received when there is a reasonable expectation that the principal will be collected. The Commissioner said that the excess is income under the general definition and cannot be treated as capital because the payments are neither on a sale nor received on retirement of indebtedness issued by a corporation (Section 117). This court holds that ruling invalid. The defaulted coupons taxpayer purchased were indebtedness of the corporation; she had capital gain. *Rickaby Estate,* 27 TC No. 109.

Jury finds feed miller bought stock to get source of supply. Taxpayer, who was in the feed-milling business, claimed an ordinary loss on the sale of stock of a corporation producing soybean meal. The court instructed the jury to determine whether taxpayer's motive in buying the stock was to obtain the right to buy the same proportion of soy meal it produced as he held stock. The jury finds that was his motive and holds for taxpayer. *Todd,* DC Ga., 1/8/57.

Carrier gets capital gain on sale of trailers to its haulers. Taxpayer was a common carrier, but the actual hauling was done by independent owner-operators or "brokers." As taxpayer was able to purchase equipment at a fleet discount greater than could be obtained by the brokers, it ordered trailers for those brokers requesting them and then entered into a deferred-payment arrangement with the brokers whereby title would pass after six months. Until such time the brokers could use the trailers but only to haul for taxpayer. The court allows taxpayer to take depreciation on the trailers while it retained title. Noting that profits realized on such sales were relatively minor, the court holds the trailers were property held by taxpayer in its trade or business for over six months and qualified as Section 117(j) (equivalent to 1954 Code Section 1231) assets. The gain thereon being capital gain was therefore properly excludable from taxpayer's excess profits net income. *McCullough Transfer Co.,* 27 TC No. 100.

DEPRECIATION

Flying school could depreciate equipment over short estimated life of school. Taxpayer operated several schools for cadets during World War II. In 1942, taxpayer had conferred with Air Corps personnel on the question of depreciation, and taxpayers decided that December 31, 1944 was a likely cutoff date. This estimated useful life was accepted for renegotiation. The equipment whose useful life was expected to end then included barracks, mess-hall equipment, shop tools, firefighting and office equipment. Actually, taxpayer's schools were closed in 1944, and the assets sold at a profit. The court allows the depreciation as computed over the period ended December 31, 1944 as reasonable, but it requires a 10% adjustment for estimated salvage value. *Cohn,* DC Tenn., 2/25/57.

Procedures re depreciation agreements outlined. Forms and procedures to be used for executing and modifying agree-

ments as to useful life, method, and rate of depreciation of business property is prescribed by the Service. *Rev. Proc.* 57-10.

ACCOUNTING METHODS

Increase in state income tax accrues when liability fixes. An additional state income tax assessment accrues as a tax deduction to an accrual basis taxpayer when the amount is finally determined by litigation or default, or when the taxpayer acknowledges his liability for the amount of the increase. *Rev. Rul.* 57-105.

Initial payment not prerequisite for use of the installment method (old law). Taxpayer, a stockholder of a water company, sold part of his stock to the city of Phoenix and agreed to sell the remaining shares back to the corporation itself. The sole payment from the company was a note payable over three years. He reported the gain on the installment method. The Tax Court held valid the Regulations under the 1939 Code providing that the installment method could be used only if an initial payment was received in the year of sale. This court reverses. The Code did not expressly require an initial payment. [1954 Cole does not require receipt of an initial payment in the year of sale. *Ed.*] *Gilbert*, CA-9, 2/15/57.

Publishers deferring subscription income may deduct circulation expenses. In 1940, the Service ruled (*IT* 3369) that prepaid subscriptions can be reported as income over the subscription period if that had been taxpayer's practice. [See 6 JTAX 132, March 1957 on industry complaints on inequitable enforcement of this Ruling and disregard of *Beacon Publishing* (218 F2d 697) which held that such deferral is proper accounting. *Ed.*] That Ruling required that applicable expenses be also so deferred. Thereafter, in 1950, the Code was amended (Section 23(bb)) retroactively to 1945, to permit the deduction of circulation expenses as accrued. The Service now rules that *IT* 3369 is modified also retroactively to 1945 to permit a publisher who defers subscription income under *IT* 3369 to deduct expenses concurrently as authorized by Section 23(bb). This applies retroactively to only those years open at the time of this Ruling. *Rev. Rul.* 57-87.

Advertising agency reporting sale when contract signed needs consent to defer until performance. Taxpayer supplied advertising copy and related services under contracts, generally for a 12-month period. Prior to 1945, taxpayer, on the accrual basis, reported the full amount of the contract price as a sale when the contract was signed. Expenses were accrued. The Tax Court held that taxpayer cannot, without the Commissioner's prior consent, recast its sales account to defer income to the years covered by the contracts. Taxpayer argued that it was in error in its method for prior years; it was making a correction, not a change. The court said there were many methods of accounting for income on an accrual basis, all of which are acceptable if consistently used. Taxpayer clearly changed its method of accounting and required consent. The Commissioner's action in recomputing income by the old method was not arbitrary; it is not the function of the court to determine the relative merits of different methods. This court affirms. *Advertisers Exchange*, CA-2, 2/18/57.

Cost-plus fee accrues when determinable; progress payments when received [*Acquiescence*]. By the end of 1949, taxpayer, an electrical contractor on the accrual basis, had been at work under a construction contract for approximately 2½ years. At that time the work was more than 95% completed. The contract called for reimbursement in full for the accrual costs plus a base fee of 7½% of a "cost estimate" to be adjusted at the completion of the job. Payments of 95% actual costs, and a portion of the 7½% base fee, were made to taxpayer as the work progressed, and the actual collections were included in income. The withheld amounts and the bonus were received by taxpayer in 1950, the year before the court. The court holds these payments were not income in 1950. They were properly accruable in prior years when the amount due was ascertainable. *Dingle-Clark Co.*, 26 TC 782, *acq.* IRB 1957-6.

Service won't issue Regulations on changes in methods now. Section 487 of the 1954 Code authorizes the Treasury to make adjustments in income in order to prevent duplications and omissions when changes in accounting methods are made. However, no adjustment can be made for items that were or should have been taken into account prior to January 1, 1954. The Treasury announces it will not issue Regulations on Section 487, nor will it act on applications for changes which involve 481. The reason given is that there is a possibility of legislation on this subject. *TIR* 41.

Commissioner's acceptance of returns after unauthorized change of method is implied approval. Taxpayer changed its method of reporting from an accrual to a cash basis in its 1932 return. Concededly the change was improper because the taxpayer had not requested permission. However, the Commissioner's contention that such a change could not be effected without his prior consent is rejected by the court. The 1932 return had shown the change in method, and on subsequent returns it was stated the cash basis method of reporting was used. By not objecting for fifteen years, the Commissioner implied consent to the change; he cannot now withdraw approval. [Apparently the question of whether the cash method fairly reflected income was conceded. The findings of fact state that the government admitted "in argument and in its brief that the cash method of accounting . . . by plaintiff correctly reflects the income . . . as it does any taxpayer filing on the cash basis." *Ed.*] *Tampa Tribune Publishing Co.*, DC Fla., 1/30/57.

Bound by installment election despite later default on notes received. The court found voluminous facts about taxpayer's dealing with a corporation, of which he was a principal stockholder, and it determined his basis for the shares. It finds he sold his preferred and common in one transaction and properly reported the gain on the installment

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basis. At issue here is the loss on worthlessness of the installment obligations three years later. No discussion is made of the issues. *Felton,* DC Ga., 1/28/57.

DEDUCTIBILITY

Truckers' overweight fines not deductible. Taxpayer, a trucking company, paid fines levied in the various states for violations of laws prescribing maximum weights, loads, and sizes of vehicles. The violations were all innocent, resulting from such things as the shifting of the freight in the truck while on the road. Nevertheless, the district court held the fines to be penal and therefore not deductible. The cases allowing deduction of OPA penalties were not controlling, it said, because the price-control law itself distinguished between willful and innocent violators. This court affirms. *Hoover Motor Express, Inc.,* CA-6, 1 1/4/57.

Arbitrary writedown of inventory on bulk sale allowed [*Acquiescence*]. Taxpayer contracted to sell his business at a price determined in part by an inventory to be taken. He agreed that the price would be $3,000 less than cost. The Commissioner disallowed the deduction on the ground that it was not bona fide. The Tax Court held that the parties negotiated the price at arm's-length; taxpayer really sold inventory at a loss which must be allowed him. *Friedlaender,* 26 TC No. 130, *acq.* IRB 1957-6.

Overceiling wage payments disallowed. A partnership engaged in the building-construction business paid overceiling wages to bricklayers and foremen in violation of the Defense Production Act. The court holds the excess amounts were properly disallowed as a deduction from partnership income. Taxpayer argued that the wages constituted a part of its "capital cost" and that under the Sixteenth Amendment a tax can be laid only on income arising after all investment is recouped. This court stands by its position in *Weather-Seat* (16 TC 1312, aff'd, CA-6, 199 F2d 376). There it held that the price-control laws in effect provided that overceiling wages are not reasonable compensation. *Zehman,* 27 TC No. 107. Similarly, *Solon Decorating Co.,* TCM 1957-35.

Cost of pond on farm to be capitalized. The cost of a pond that taxpayer-farmer built primarily for irrigation and watering cattle is a capital expenditure. It is therefore not deductible as a business expense. *Gulledge,* TCM 1957-29.

Seventh Circuit rebukes Tax Court and Commissioner for not allowing bookmakers' rent and wages. The court points out with some asperity that it had held in *Doyle* (231 F2d 635) that rent and wages may be deducted by an Illinois bookmaker because such an allowance would not be contrary to sharply defined public policy. The Commissioner's new argument, presented here, is that payment is contrary to Illinois criminal statutes. That theory is met, the court observes, by the reason given in *Doyle:* the Code allows deductions of all expenses and makes no distinction between lawful and unlawful expenses. The court criticizes the Commissioner for neither following *Doyle* nor requesting certiorari. The Tax Court is likewise at fault in not following *Doyle* as the rule of the circuit in which the case arose. [The Tax Court has stated that as a court of national jurisdiction it is not obligated to follow the various circuit courts. *Ed.*] *Sullivan,* CA-7, 2/13/57.

Can deduct payment for settlement of unsuccessful job despite lack of legal obligation. Engineering and designing costs, incurred by a subcontractor were reimbursed by taxpayer in connection with an unsuccessful effort to manufacture a household appliance. The court allows it as an ordinary and necessary business expense even though there was no "legal obligation" to make the expenditure. *Waring Products Corp.,* 27 TC No. 114.

Unexpended portion of advertising fund not deductible. Taxpayer-corporation, a manufacturer of appliances, agreed with its distribution to set aside 10% of its net sales to be used for demonstration and advertising expenses. The distributor was authorized to draw on the fund for costs actually incurred. The court holds that to the extent actual payments were made by taxpayer out of the fund it was entitled to a deduction. However, with reference to the unexpended portion of the fund, since no fixed obligation had as yet been created against the taxpayer or the fund, no deduction was accruable. *Waring Products Corp.,* 27 TC No. 114.

Officers in constructive receipt of accrued corporate expenses; deduction allowed. Salary, rent, and interest expenses were accrued on taxpayer's books but were not actually paid in cash to the payees, who were controlling stockholders, within 2½ months after the close of the taxable year. The Commissioner disallowed them as unpaid expenses owed to related stockholders and nondeductible under the Code. The court finds that during the 2½-month period taxpayer could have borrowed sufficient funds to pay the amount accrued, and holds that the amounts credited to the payees were includible in their income under the doctrine of constructive receipt. The claimed deductions were therefore not barred. *Geiger & Peters, Inc.,* 27 TC No. 113.

Land seized for taxes sold to related taxpayer; no loss allowed. A tract of land owned by taxpayer was seized in 1940 by the county for nonpayment of taxes and was sold in 1946, after taxpayer's right of redemption in the property was terminated to a corporation wholly owned by taxpayer and his family. The court holds taxpayer is not entitled to a loss deduction on two grounds. First, he had never abandoned the property; second, the seizure and sale constitutes an indirect sale between related taxpayers so that recognition of the loss would be precluded by 1939 Code Section 24(b)(1)(B). *McNeill,* 27 TC No. 111.

Can deduct repair expense though part of a remodeling program. The expenditures deducted as repair expenses were for painting barns and fences, replacing rotted boards, and patching roofs. Taxpayers had purchased a dairy farm as a source of supply for a World War II air cadet school. The court allows the deduction: the expenditures did not materially enhance the value or add to the life of the property; they were ordinary and necessary repairs although made during an expansion and remodeling program. *Cohn,* DC Tenn., 2/25/57.

Pre-operating expenses should be amortized over expected life of business. Taxpayers operated several air cadet schools during World War II. Expenses incurred prior to opening the schools (training

instructors, and legal fees for negotiating leases), are held to be capital items and amortizable over the life of the schools. *Cohn,* DC Tenn., 2/25/57.

Third Circuit joins Sixth in disallowing overweight truck fines. Taxpayer paid some $38,000 in 1951 as Pennsylvania fines at $50 and $25 apiece for overweight trucks. The findings of fact set out the economic position of the taxpayer: due to competition with railroads, etc., he had to use trucks of a size that would be overloaded; the state collected the fines but made no attempt to stop the practice; its weight limits were below those of other states. The Tax Court holds, however, that to allow the fines would be contrary to public policy. This court affirms. It notes that the Sixth Circuit in the *Hoover Motor Express Co.* (1/4/57) reached the same decision. *Tank Truck Rentals, Inc.,* CA-3, 3/6/57.

WHAT IS INCOME

Achievement awards nontaxable despite required application and interview. The required filing of a written form and the appearance for a personal interview by a student selected for an award in recognition of his past academic and citizenship achievements does not constitute participation in a contest or proceeding within the meaning of Section 74, and the award is accordingly nontaxable. *Rev. Rul.* 57-67.

Interest on GI insurance deposits not tax-free. Interest on GI life-insurance dividends left on deposit with the Veterans Administration are no longer tax-free. Dividends themselves remain tax-free. *Vet. Admin. Release,* 2/14/57.

Interest on funds deposited with an insurance company taxable when earned. Taxpayer received $3,000 a year from an insurance company out of a fund comprised of the total surrender values of two policies. Taxpayer did not report the $3,000 as income on the theory that it was received under a life-insurance or endowment contract and did not exceed the premiums or consideration paid. The Tax Court held the payment was taxable to the extent of $2,955, the interest credited to his account for the year. This court affirms. One contract was an endowment policy, and returns on it would be tax-free until the total cost was recovered. But the other policy was not insurance; it had provided for an annuity in the future but was surrendered prior to the annuity becoming due and had no life-insurance protection. The fund being mixed, no part of the $3,000 can be identified as paid on insurance. The amount credited is income under the general definition. *Zimmerman,* CA-8, 2/4/57.

Payment to employee's widow a gift (old law). Her husband's employer paid $13,000 to the taxpayer in 1952. No salary was owed for the husband's services, and there was no obligation to make any such payment. The payment was stated to be in recognition of the husband's prior services. The court rejects the Government's argument that the corporate policy of making such payments to widows of all deceased executives had in effect turned what would originally have been a gift into the payment of an obligation. The amounts of the various gifts over a period of years to widows of executives did not indicate a regular pattern such as to suggest an obligation under a plan. The court declined to follow *IT* 4027, in which the Commissioner stated that payments to a widow on account of her husband's services are income. The comment on the prior law made by the Senate Finance Committee in 1954, implying that noncontractual payments prior thereto were taxable, is, the court holds, a misinterpretation. [See comment page 288. *Ed.*] [Section 101(h) of the 1954 Code exempts the first $5,000 of death benefits whether paid under contract or gratuitously. *Ed.*] *Rodner Estate,* DC N. Y., 2/6/57.

Determination of income from expenses upheld. Taxpayer explained the source of her living expenses were gifts, but the court rules she gave sufficient consideration to negative a gift: she gave up her activities as a prostitute for which she had been convicted several times. In reconstructing the income of taxpayer and her husband, the Commissioner added to their known expenditures estimated living expenses of $2,000. The court adjusts the computations after finding that $1,200 adequately covered all of their living expenses. Penalties for failure to file returns and failure to estimate probable tax due are upheld by the court. *Brizendine,* TCM 1957-32.

Jury finds that improvements by lessee were not rent; not income to landlord. The Code provision on improvements by a lessee on the lessor's property says that "gross income does not include income (other than rent) . . . representing the value of . . . improvements." The jury was asked here to determine whether improvements required to be made by the lessee under the terms of the lease were rent. It finds that they were not. *Neel,* DC Ga., 1/9/57.

Income from sale of stolen goods. Taxpayer, a shipping clerk, stole goods from the company that employed him. The goods were sold and the proceeds divided with confederates. No records were available to determine proceeds, but the court finds the Commissioner's estimates reasonable and, since they were supported by taxpayer's voluntary confession, adequate. It affirms the Tax Court decision that the proceeds were taxable income, not the embezzled proceeds of another. Fraud penalties are also sustained. *Schera,* CA-6, 2/18/57.

WHOSE INCOME

Income from farms leased to wife taxable to husband. Taxpayer, a physician in Monmouth, Illinois, had for many years owned four tracts of farmland, managed and operated by tenants. In 1942, he leased the farms to his wife, subject to the agreements with the tenant farmers. The rent paid by the wife was measured by the real-estate taxes, repairs, insurance premiums, and part of the cost of any capital improvements. They filed separate returns; he included only the rent received from his wife; she reported the income from the farms less rent paid. The district court held that this was not a bona fide leasing arrangement, and the taxpayer still enjoyed, and was, therefore, taxable on, the net income derived from the farms. The Seventh Circuit affirms. This was an assignment of income, not a lease. *Winters,* CA-7 12/11/56.

"Gift" to wife ignored; income taxable to donor. Taxpayer made a gift of corporate bonds to his wife. Thereafter, the corporate stockholders and bondholders in liquidation contributed their interests to a trust, of which taxpayer was trustee. The district court found that there was no gift of the bonds

to his wife, that taxpayer was a grantor of the trust, and that he was taxable on the trust income. This court affirms. *Goldsmith*, CA-2, 2/27/57.

Sales by stockholder are corporate income and dividends to her [*Acquiescence*]. Decedent was the sole stockholder of National Thread Co. until she transferred all her stock to her husband. Sales of over $156,000 made by him as an individual during the years 1942-45, as well as some $22,000 of unidentified bank deposits in his and decedent's name, were held to be in substance sales of National Thread and taxable to it. The proceeds were also constructive dividends to decedent and her husband, taxable as ordinary income to the extent of the corporate earnings and profits. The Commissioner acquiesces in the allocation by the Tax Court of unidentified bank deposits, the allowance of 25% of unreported costs, the allowance of some travel expense, and the finding that there was no fraud in 1942 when errors were small. *Stein*, 25 TC 940, *acq.* IRB 1956-8.

OTHER ACCOUNTING DECISIONS

Loss on gas well disallowed for failure of proof. A claimed loss from an investment in an unproductive gas well is disallowed; taxpayer failed to show that the investment was actually made or that it became worthless in the taxable year. *Dalton*, TCM 1957-20.

Loss carryover denied for failure of proof. Certain tools and equipment which taxpayer used in his employment and which he intended to use in his future business were destroyed by fire. As taxpayer failed to prove that such loss was in excess of his income for the same year, the court holds he was not entitled to any net operating loss carryover. *Palmer*, TCM 1957-19.

Unproductive lease expiring on first day of taxable year a loss then. Taxpayer deducted in 1945 the cost of a five-year oil lease expiring January 1, 1945. The Tax Court held he did not prove it had value on that date. There could be no further drilling on one day; the loss occurred prior to 1945. This court reverses. Any loss of an investment in an oil lease is sustained at the expiration of the lease, unless there was a definite abandonment prior to the termination thereof. There was no such abandonment in this case. The lease expired at the end of January 1, 1945, since the first day of the period is excluded. Therefore, the loss was incurred in 1945 and not the prior year. *David*, CA-7 3/1/57.

Policyholder not taxable on interest of matured endowment uncollectible for ten years. Taxpayer was beneficiary of an endowment policy. Eighteen months before its maturity, she directed the company to retain the proceeds at maturity and to accumulate interest on the principal sum for a period of ten years. The Tax Court held that she must report the interest annually as earned. It said: "Petitioner has deliberately turned her back on income and has in effect selected the year in which she will report it. This she may not do . . . Petitioner . . . cannot escape income tax by directing that accrued interest be accumulated for her benefit in the future." This court reverses with a brief opinion that the pre-maturity agreement was real and at arm's-length. The court also points out that the agreement provided her with a higher return "than would otherwise have been available if she had continued to receive only current interest payments." Finally, it notes that in the years before the court she received nothing and had no right to receive any of them. *Fleming*, CA-5, 2/1/57.

Operating loss not reduced by EPT refund arising from its carryback. In computing an operating loss carryover, a taxpayer is permitted to include as an expense excess profits tax paid or accrued. The Commissioner argued here that an excess profits tax refund must therefore be included as income. The court holds that the Code does not so require. Taxpayer here had a 1946 operating loss which resulted in a 1944 excess profits tax refund received in 1947. At issue was the amount of 1946 loss available for 1947. The Commissioner argued that the 1944 excess profits tax refund accrued either in 1946 (when the loss was suffered) or in 1947 when the refund was received, and that in either year it should reduce the operating loss. This court holds otherwise. First, the argument that taxpayer can be allowed an operating loss only if it is a true economic loss was expressly rejected by the Supreme Court in *Lewyt* (349 U.S. 237). Second, there must have been an excess profits tax refund in *Lewyt* also, but the court made no adjustment for it. Lower Federal courts should not disregard a Supreme Court holding on the ground that a certain legal point had not been raised. *Budd Co.*, DC Pa., 2/20/57.

Income in dispute not taxable on receipt [*Acquiescence*]. In 1920, taxpayer received funds in settlement of a dispute over stock. The Board of Tax Appeals held that the amount was not income in 1920 because the right to receive it became fixed prior thereto. *Selwyn Eddy Co.*, 25 BTA 1341, *acq.* IRB 1957-6.

Capital gain on sale of immature cattle from dairy herd. Taxpayers owned a dairy and breeding herd. They had to satisfy an increased demand for milk from three World War II air cadet schools. The cows were inspected periodically from the time of their birth and those below herd standards were sold. The court holds that even young calves which were not yet milk producers or breeders were Section 117(j) assets. *Cohn*, DC Tenn., 2/25/57.

BAD DEBTS

Loans by attorney deductible only as nonbusiness bad debts. Bad debts incurred by a practicing attorney who made individual loans and accommodation endorsements are held deductible only as a nonbusiness bad debt. The attorney was not in the business of lending money, and the loans bore no proximate relationship to his law practice either when made or when they became worthless. *McNeill*, 27 TC No. 111.

Securities' basis is not reduced by bank's writedowns ordered by bank examiners. In prior years, bank examiners wrote down taxpayer-bank's investment, and the bank claimed deductions. In the year of sale of the securities, now before the court, taxpayer claims a basis unreduced by the writedowns. (It was conceded that if taxpayer won here the Government would be permitted under Section 3801 to open the otherwise closed year of writedown and to assess additional tax.) The court holds that the basis is the full purchase price. The writedowns were mere estimates; loss was not sustained until sale. *Merchants National Bank*, DC Kans., 12/3/56.

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Salary to executive's widow: Did Congress unwittingly make "gifts" impossible

When Congress extended to noncontractual payments the $5,000 exemption on post-death compensation, did it make it impossible for a firm to make a post-death "gift" in any larger amount? Simple logic says that if the law specifically excludes $5,000 of noncontractual payments, the inference is inescapable that amounts over $5,000 are taxable.

And this is the inference drawn, as dicta only because the case concerned pre-1954 payments, by the District Court for the Southern District of New York in *Rodner* (see page 286). The court commented on the change and how it affected not only taxability of noncontractual payments in 1952 but also the status of noncontractual payments over $5,000 after 1954. Here's what the court had to say about the current tax status of over $5,000 noncontractual payments:

Current tax status

"In the complete revision effected by the 1954 Code, the general language exempting gifts is controlled by the particular language of Section 101(b) limiting the exemption of death benefits to $5,000. Gifts in general are exempt but gifts in the form of death benefits are taxable insofar as they exceed $5,000."

The Commissioner's position on this is simple: *IT* 4027 holds that payments to the widow of a deceased employee in recognition of his services is taxable income.

The courts have dealt harshly with the Commissioner on this point. In *Rodner*, the Court summarized the history of litigation in this area. It queried: 'is a gratuitous payment by an employer to a presumptive beneficiary of a deceased employee a gift? In every case where the question has been squarely presented, the answer has been in the affirmative."

In accord with these cases, the court holds in the *Rodner* case that the payment there, in 1952, was a gift. It specifically disagrees with the Commissioner's position: "*IT* 4027 modifies the earlier *IT* 3329, which stated: 'When an allowance is paid by an organization to which the recipient has rendered no service, the amount is deemed to be a gift or gratuity and is not subject to Federal income tax in the hands of the recipient.' The new Ruling, *IT* 4027 states: 'It is the position of the Bureau that irrespective of a plan, voluntary or involuntary, definite or indefinite, payments of the type herein considered constitute taxable income, and it is held that payments made by an employer to the widow of a deceased officer or employee, in consideration of services rendered by the officer or employee, are includible in the gross income of the widow for Federal income tax purposes.' I take it that this means that, even though the transfers to the widow are 'gifts in recognition of' rather than 'payments for' former services, to use the language used in a somewhat different connection in *Bogardus* (302 U.S. 34), the amounts thereof constitute taxable income . . . I disagree."

Thus far the whole problem is merely the usual conflict between the Commissioner and the courts. The Commissioner takes the flat position that all payments are taxable compensation, and the courts look at the facts in each case and frequently find a clear donative intent.

The Senate Finance Committee view

But the argument is confused by a remark of the Senate Finance Committee about the law prior to the change. If the Committee was right, noncontractual payments are taxable, in full prior to 1954 and over $5,000 thereafter. The *Rodner* opinion says flatly that the Committee was wrong in implying that pre-1954 contractual payments were taxable. It adds, as dicta because post-1954 payments were not involved in this case, that it agrees that post-1954 noncontractual payments over $5,000 are taxable.

The court first reviews its view of the pre-1954 state of the law: gratuitous payments are nontaxable gifts; contractual payments are income except for the first $5,000. It says: "Report No. 1622, 83d Congress, 2d Session, of the Senate Committee on Finance on the proposed Internal Revenue Code of 1954 deals with the provisions of the then existing income tax law which, in effect, exempted $5,000 of payments made under a contract of an employee providing for payments to a beneficiary of an employee by reason of the death of the employee . . .

"By those provisions Congress excluded from gross income . . . the first $5,000 . . . paid . . . pursuant to contract . . . Benefits paid . . . pursuant to contract are not exempt as gifts. I do not believe that Congress would favor exempting up to $5,000 death benefits paid pursuant to contract but taxing the whole of gratuitous death benefits. If I am right in thought, the provision in Section 22(b)(1)(B) of the Internal Revenue Code of 1939 limiting the $5,000 exemption to death benefits paid under contract was in perfect harmony with the above cited cases which hold gratuitous death benefits to be exempt as gifts. The legislative intention seems to me to have been that all death benefits that were gratuitous should be exempt and all over $5,000 that were paid under contract should be taxable."

The Committee view is in error

Turning now to the confusing remarks of the Committee, the court finds that these remarks do not agree with its own view of the law before 1954 and that it is forced to conclude that the Committee was in error. It says that the 1954 Code "eliminates the provisions limiting to contractual death benefits . . . the $5,000 exemption. To me the effect of this would seem to be to withdraw the complete exemption that gratuitous death benefits had enjoyed and to substitute an exemption up to $5,000.

"That does not seem to have been the view of the Senate Committee on Finance of a subsequent Congress, however. In the Report referred to . . . the Committee deals with this very change and says 'the exclusion is made available

regardless of whether the employer has a contractual obligation to pay the death benefits.' That language is certainly that of someone who thinks that the new provision extends a boon instead of a burden to the recipients of gratuitous death benefits. With the utmost respect, I believe that the Committee's view of the prior law was a misinterpretation. Even if the Congress itself were to solemnly declare the meaning of legislation adopted at a previous session it would have no more effect than an executive interpretation . . . Thus I am not required to accept the interpretation of the Senate Committee and I adhere to my view that gratuitous death benefits were wholly exempt until the effective date of the Revenue Code of 1954."

However, as to post-1954 noncontractual payments all three authorities are in agreement that they are taxable over $5,000. The Commissioner has always insisted they were. The district court said, but only as dicta, that the 1954 change removed such gifts from the nontaxable category for amounts over $5,000. And the Senate Committee said it was giving an exclusion up to $5,000, thus implying that amounts over that were taxable. ☆

More on Casale: decision was wrong because there was no severance of corporate property

by **MORTON LEVINE**

At first glance, the Casale case seemed to be right in all respects but one: insolvency could destroy the benefit to the owner-employee who was being taxed on the premiums for a deferred-compensation agreement funded by life insurance. But this author adds another objection; the decision, he says, was wrong because at no time was there a severance of corporate property. Pointing to decisions that ownership cannot be attributed to the owner individually unless such severance actually occurred, he reviews the important court cases.

THE CASALE DECISION was in error because, for tax purposes, the premiums on the insurance policy were not unqualifiedly subject to Casale's demand in the taxable year before the Tax Court. He never *intended* them to be subject to his demand in *that* year, and the corporation had not given up sufficient control over the insurance policy so as to qualify the premiums as a taxable distribution. The facts of the case bear out this contention.

The facts of the case

Casale was the 98% owner and president of a corporation which took out a $50,000 life-annuity policy on his life in connection with a deferred-compensation agreement. The annual premium was $6,000. The corporation was the owner of the policy, could borrow against it, was the beneficiary and obtained all other indicia of ownership. The deferred-compensation agreement, provided that Casale would receive pension payments of $500 a month for life, effective 13 years from the date of the agreement (with ten years certain), or that his beneficiaries would receive a lump sum of $50,000 if he died before the 13-year period ended. The Tax Court ruled that the deferred-compensation agreement lacked bona fides, and that the $6,000 premium payment represented a distribution equivalent to a dividend, which was, of course, taxable at ordinary income tax rates.[1]

Intention and "unqualifiedly" subject

The Regulations have long held that dividends are taxable to stockholders in the year in which "the cash or other property is unqualifiedly made subject to their demands,"[2] and this rule applies equally to publicly owned corporations and one-man corporations.

The word "unqualifiedly" requires some analysis, particularly in the case of close corporations. In a practical sense, all the property of a corporation (net of debt) is "unqualifiedly" subject to the demand of its sole stockholder, because all he has to do to obtain the property is transfer it from his corporate pocket to his individual pocket. Nothing qualifies his right to demand and receive the corporation's property. Under this view of "unqualifiedly," the earnings and profits of a one-man corporation would become immediately taxable to the stockholder as a dividend as they are earned. Obviously, this is not the sense in which "unqualifiedly" is used in the Regulations.

The sense in which it is used recognizes as reality the fiction of the corporate entity. In and of itself, this fiction is sufficient to make a sole stockholder's right and power to receive his own corporation's property only qualified.

Before a sole stockholder can be said, in a legal sense, to have an "unqualified" right to his corporation's property, he must take some affirmative action to sever the property from the corporate entity. One action required is a manifestation of *intention* to transfer corporate property from the corporate pocket to the individual pocket. This manifestation may be by substantive action e.g. actually withdrawing corporate property, or by purely formal action, such as declaring a dividend, payable on a date certain. In the case of a formal declaration of a dividend, if the stockholder's[3] other conduct does not contradict his formal manifestation of intention, the dividend is deemed "unqualifiedly" subject to his demand on the date it is payable, but not before.[4] The Commissioner may not substitute his judgment for the stockholder's as to when the dividend should be made payable. Decision as to the date of payment is solely within the discretion of the stockholder.

For example, a sole stockholder on December 31, 1954 has his corporation formally declare a dividend payable January 2, 1955. Assume there are sufficient funds available so that the dividend could have been declared payable on December 31, 1954. The dividend is taxable in 1955, the date *intended* for payment, notwithstanding that by merely changing a date the stockholder had it exclusively within his power to make the dividend payable in 1954.

The cases support the above view that a dividend is taxable when *intended* to be payable.[5]

In the *Avery* case, the United States Gypsum Corporation declared a dividend in November 1929, payable on or before December 31, 1929. In compliance with its normal procedure, all dividend checks were mailed on December 31, 1929 except those checks for stockholders who were also officers and employees, and those were held in the

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treasurer's office until the first business day in January, 1930, and then distributed. The taxpayer in this case was the president of the U. S. Gypsum Corporation and he actually received his 1929 dividend from the treasurer's office on January 2, 1930. The Commissioner contended that the dividend was taxable when declared and made payable, that is, in 1929, but the U. S. Supreme Court rejected this contention. It held that the dividend was not taxable until 1930 when it was *intended* to be paid:

"There is nothing to show that petitioner could have obtained payment on December 31, he did not expect this, and the practice shows the company *had no intention* to make actual payment on that day" [Emphasis supplied].

Although the *Avery* case involved a publicly owned corporation, the principles of that case have been applied to dividends paid by a corporation to its virtual 100% parent in *Royal Baking Powder Corporation*,[6] and to dividends paid to individuals who were stockholders of a relatively closely held corporation in the *Query* case.[7] Judge Black's opinion in the *Query* case is particularly informative:

"It therefore seems reasonably clear to us that the dividend of the corporation, although declared on December 31, 1948, was not to be paid until January of 1949. The uncontradicted evidence shows that the dividend was actually paid to stockholders on February 14, 1949. Because of these facts and circumstances, under the doctrine of the Supreme Court in *Avery v. Commissioner*, . . . we hold against the Commissioner's contention that petitioner constructively received his dividend of $8,400 in 1948. Petitioners are on the cash basis and the dividend is taxable to them in 1949. It is true that the cash position of the corporation would have enabled it to pay the dividend in 1948, but taking into consideration all the evidence in the case, we conclude *there was no intention to pay it prior to early in 1949*." [Emphasis supplied]

Applying the above principles to *Casale*, did Casale intend a dividend, and if so, in what year? Accepting Judge Rice's findings of fact, it appears clear that a dividend was intended. The deferred-compensation agreement served no economic purpose since the taxpayer hadn't proved that the services rendered by him entitled him to compensation in addition to his regular salary. In essence, the deferred-compensation contract appears to have been a camouflaged informal declaration of a dividend.

Granting a dividend was intended, *when* was it intended to be paid? It appears reasonably clear from the terms of the deferred-compensation agreement that it was intended to be paid, not in the current year, but thirteen years hence, or at some earlier future date if Casale died before reaching retirement age. Casale was trying to use corporate funds to secure his future. He was not interested in using the corporate funds for immediate direct benefits. This intention should be given effect just as it was in the *Query* case.

Casale's intention to pay a future dividend rather than a present one does not dispose of the case. There still must be considered, as indicated above, whether despite this intention, his conduct was so inconsistent with the expressed intention as to constitute the severance of sufficient corporate control of the insurance policy in his personal favor as to qualify the insurance premiums as a dividend distribution.

Corporate surrender of control

The year that a dividend is intended is not the sole criterion to be considered; the corporation's conduct must be consistent with its expressed intention. Where the expressed intention as to the time of payment is ignored and a dividend is prematurely distributed, either actually or constructively, the dividend is taxable at the time of disribution.[8]

It is impossible to determine the exact quantum of control over property which must be surrendered by a corporation in favor of its stockholder to make the property a dividend distribution to the stockholder. However, a sole stockholder's control of the corporation's property is not sufficient in and of itself to constitute the surrender of control of such property by the corporation. The corporate barrier is an imposing one,[9] and something substantial must be done by the corporation to surrender control of such property before the corporate shell can be unlocked. While the cases quite properly make no attempt to set a hard-and-fast rule as to precisely how much control of property must be surrendered to constitute a distribution in favor of the stockholder, they do set forth some helpful guides.

Constructive receipt. If the date intended for a distribution arrives and the controlling stockholder unilaterally fails to cause the corporation to distribute the property, he is deemed to have taken it anyway, and the corporation is considered to have given up control of the property.[10]

Corporate loans to stockholders. If the stockholder's stated intention to repay the loan is contradicted by his conduct in not having made any attempt to repay the loans over a long period of time, then too, the corporation is deemed to have given up sufficient control of the property "loaned" to the stockholder so as to constitute it a dividend distribution, notwithstanding the corporation's legal right to repayment as a creditor of the stockholder.[11]

Life insurance. If the stockholder is designated beneficiary of a policy while the corporation remains the owner, the designation as beneficiary may be sufficient to make the policy a distribution to the taxpayer so that premiums paid by the corporation are taxable as a dividend, even though the corporation could technically cash in the policy and recoup at least a portion of the premium payments via cash-surrender value.[12]

The above examples have one underlying similarity: a direct and substantial severing of corporate control over the property for the immediate personal benefit of the stockholder. There is a breaking-down of the corporate barrier which otherwise prevents a stockholder from enjoying, directly for his personal benefit, the property of his corporation. In each of the examples further substantial action by the corporate entity is unnnecessary to benefit the stockholder. In the constructive-receipt cases, the corporation has already taken the necessary action by declaring and making payable the dividend on a date certain. All the stockholder need do is take the dividend earmarked property. In the loan cases, the taxpayer has already

[1] 26 TC No. 131 (September 12, 1956). See 5 JTAX 340. GCM 13198, XIII-I CB 218,220.
[2] Reg. 118, Sec. 39.115(a)-1(d); Reg. 118, Sec. 39.42-3.
[3] For purposes of simplicity, at times the word "stockholder" is used to describe all acts of a sole stockholder whether they be as director, officer or stockholder.
[4] Even if not actually paid on the payment date, it will be deemed to have been received constructively on that date. GCM 13198, XIII-I CB 218, 220; St. Clair Estate Co., 9 TC 392 (1947), appeal dismissed Nov. 3, 1948—CCA-9.
[5] Avery, 54 Sup. Ct. 674 (1934); D.D. Query TCM 1954-160 (1954).
[6] 47 BTA 370 (1942).
[7] D.D. Query, supra, note 5.
[8] Leon S. Herbert, 32 BTA 372 (1935), affd, 81 F2d 912 (3d Cir. 1936) (premature credit of dividend to loan due from stockholder to corporation).

taken property out of the corporation, and the corporation by silence has indicated no intention to get it back. In the life-insurance cases, the corporation has designated the stockholder as beneficiary so that upon his death the life-insurance proceeds would be payable directly to the stockholder without further action by the corporation.

Corporation retains control

If the corporation retains some measure of control, even a relatively small amount of control, over property intended for the personal benefit of its stockholder, the courts are reluctant to pierce the corporate veil and to tax the property to the stockholder.[13]

In the *Greenspon* case, a corporation was owned entirely by the taxpayer and his wife. The taxpayer purchased a farm with his own funds, taking title in his own name, and used the farm exclusively for personal purposes and in no wise for corporate-business purposes. He had the corporation buy certain farm equipment with corporate funds, taking title in the corporate name. The farm equipment was in no way used in the corporation's business, but was used exclusively by the taxpayer on his farm. The corporation nevertheless remained their title owner and treated the equipment as an asset on its books.

The Commissioner attempted to tax to the stockholder as a dividend the cost of the farm equipment purchased by the corporation. The Tax Court, however, held that the equipment was not a dividend to the taxpayer for the reason that *title* to the equipment remained in the corporation. (The Court did not decide, because the question was not raised, whether the stockholder could be taxed on the reasonable rental value of the equipment as a dividend). Said the court:

"We do not think that the cost of these items should be added to Greenspon's personal income. It is not disputed that the title to these items remained with the corporation and, while they may have been used on the farm, Greenspon did not own them, and their cost should not be included in his income."

Very significantly, not only was this case reviewed without dissent by the entire Tax Court, but surprisingly the Commissioner has acquiesced in this decision.[14] The case was appealed on other issues by the taxpayer, and the Commissioner did not cross-appeal on this issue.

The *Greenspon* case has been followed in the *Morganstern* case.[15] A family-controlled corporation purchased automobiles which were used partially by the stockholder officers for their personal benefit and partially for corporate business. Following the *Greenspon* case, the Tax Court refused to add the cost of the automobiles attributable to the personal use of the stockholders to their income as a dividend.

Greenspon represents, perhaps, a too narrow view of the separability of corporation and stockholder, and taxpayers may be well advised not to extend it to its logical extreme, but it is illustrative of the strength of the corporate entity even in a close-corporation case, and the importance which courts give to the fiction of corporate existence.

To sum up

The *Casale* case differs somewhat from *Greenspon*. Casale had manifested an intention via the deferred-compensation agreement to receive in the future the life-insurance proceeds. Greenspon had manifested no intention to take title to the farm equipment. On the other hand, Greenspon had taken direct physical possession of the farm equipment and used it for his own immediate personal satisfaction, and these acts were insufficient to constitute a distribution to the stockholder because naked title to the property rested in the corporate entity. Unquestionably, Casale received a present benefit from the insurance policy purchased with corporate funds in the sense that he knew his future was being provided for through the corporation's ownership of the policy. This type of present benefit, however, tied as it is to future enjoyment and the necessity to penetrate the intervening corporate identity, would appear to be sufficiently indirect to prevent a present distribution of property taxable as a dividend. Casale's present benefit seems more analogous to the present benefit enjoyed by Greenspon or that accruing to a controlling stockholder who today has his corporation declare a dividend payable tomorrow. He certainly gets a present benefit in knowing that cash will be paid to him tomorrow, but he is not taxed on the dividend until tomorrow.

The life-insurance policy cases in which the insured beneficiary-stockholder is held taxable on the premiums are distinguishable from the *Casale* type of situation because in those cases the corporate entity is bypassed. The insurance proceeds pass directly to the stockholders without the necessity for an intervening corporate entity. In *Casale* a corporate entity intervenes.

Constructive-receipt cases

The constructive-receipt cases are also distinguishable because in those cases no substantial act of the corporation is necessary to distribute the dividends. They are presently payable. In *Casale* they are payable in the future.

The corporate-loan cases are distinguishable because the property had already been distributed to the stockholders and the corporation has by passage of time and silence, waived payment. In *Casale* nothing was distributed directly.

The *Casale* decision therefore fails to give sufficient emphasis to the separateness of the corporate entity and the stockholder entity. The corporate ownership of the insurance policy had sufficient vitality so as to insulate Casale from an immediate dividend tax of the premiums on the policy.

The Doran case

As a postscript it is interesting to note that the *Casale* case appears to conflict, at least in principle, with the *Thomas F. Doran* case.[16] This case was decided about three months before the *Casale* case. In the *Doran* case, a trustee pur-

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[9] For example, the *Clifford* philosophy of income taxation, as compelling in its application as it has been, does not generally apply to stockholder control over corporations. Cf. National Carbide Corp., 336 U.S. 422 (1949) with Helvering v. Clifford, 309 U.S. 331 (1940).
[10] Note 4, supra.
[11] George P. Marshall, 32 BTA 956; Crabbe TCM 1956-52.
[12] Cf. C. Francis Weeks, 16 TC 248 (1951); Paramount-Richards Theatres Inc. 153 F2d 612 (5th Cir. 1946); Casper Ranges Construction Co., 1 BTA 942 (1925). One court has not applied this rule where the sole purpose of the insurance was to benefit the corporation. Lewis v. O'Malley, 140 F2d 735 (8th Cir. 1944).
[13] Louis Greenspon, 23 TC 138 (1954); Morganstern & Co., TCM 1955-86.
[14] 1955-1 CB 4.
[15] Note 13, supra.
[16] TCM 1956-121.

chased life insurance on the lives of stockholders of a corporation under a plan whereby the insurance proceeds upon the death of a stockholder would be distributed to the living stockholders to enable them to use the proceeds to buy the stock of the deceased stockholder. The trustee at all times owned the insurance policies, was the beneficiary and paid premiums.

A stockholder died, the trustee received the insurance proceeds, and distributed them to the other stockholders. The Commissioner claimed that the trustee was an agent of the corporation that the corporation was therefore the owner of the policies, and that the distribution of the insurance proceeds was a dividend to the living stockholders. The stockholders, who were the petitioners in this case, claimed that the trustees were independent of the corporation and that the corporation did not own the policies in question. The Tax Court found for the Commissioner on the ground that the corporation was the owner of the insurance policies, the trustee being merely its agent.

The petitioners seem not to have claimed that if the corporation was deemed the owner of the policies, the distributed insurance proceeds were not dividends because the premium payments in prior years represented the taxable event giving rise at that time to dividend distributions. This would appear to be a natural corollary to the *Casale* rationale if *Casale* was correctly decided. The court too did not consider this point. Because of the court's silence, the case has only limited applicability as direct precedent in the *Casale* area, but its holding, in my opinion, represents the better approach. ☆

New compensation decisions this month

War prisoner fails to meet 80% rule on income from U. S. possession. Taxpayer was interned as a prisoner of war after being captured on the Island of Guam. Affirming the district court, the circuit court holds that the service pay he later received for the period of internment should be considered as income derived from sources within a possession of the U. S. Because of his other income in those years, however, he did not meet the requirement for excludability that at least 80% of gross income be derived from sources within a United States possession. *Newman*, CA-3, 1/7/57.

Pre-1939 state pension payments may be allocated to determine employees' basis. Contributions made prior to 1939 by a state or its political subdivisions to an employees' annuity fund are considered part of the employees' cost of such annuities. Where such employer's contributions prior to 1939 were not allocated for the benefit of specified employees at the time made, an estimated allocation may be made to determine the annuity cost to each employee, provided the method of allocation is reasonable and consistent with the retirement-plan provisions. *Rev. Rul.* 57-75.

Payments under a current-payment profit-sharing plan may be accrued. Amounts paid employees by an accrual-basis corporation under a current-payment profit-sharing plan early in the following year are accruable in the year in which the profits were earned, provided the payees and their shares are determinable by a formula prior to the close of the year, and employees receive notice of the proposed shares. If an affiliated group adopts such a plan, each member can deduct only those amounts paid to its own employees from its own profits. *Rev. Rul.* 57-88.

Allocating profit-sharing benefits by sex and age discriminatory. The Service will not issue a favorable advance Ruling on a profit-sharing plan under which the employer's contribution will be used to provide benefits allocated in proportion to the cost of providing units of retirement annuities based on annual compensation if the costs of such units are dependent upon the sex and age of the participants. *Rev. Rul.* 57-77.

Retirement age for sick-pay exclusion defined. Disability pensions paid on account of personal injury or sickness qualify as excludable sick pay until the employee either returns to work or reaches retirement age. The Service through four examples defines retirement age for purposes of terminating such exclusion. *Rev. Rul.* 57-76.

A trustee is carrying on a trade or business for self employment tax. One of four trustees of a Massachusetts real-estate trust received $3,000 as compensation for substantial services rendered. The amount is held to constitute earnings for the self-employment tax. The work he did was not negligible. It did amount to a trade or business. *Clarke*, 27 TC No. 104.

Tips are not subject to self-employment tax. Tips received by a waiter and not accounted for to his employer are not includible in computing net earnings from self-employment even though they are to be included in the waiter's gross income for income tax. The fact that no accounting is made to the employer removes them from wages as defined for self-employment tax. *Rev. Rul.* 57-71.

Five per cent of compensation may be allowed up to total unfunded cost. There are two limits on deductions for employer contributions to qualified pension plans: 5% of compensation, and normal cost plus 10% of unfunded past-service cost. The Service is here asked whether the full 5% can be deducted even if it is in excess of normal cost plus 10% of unfunded costs. It rules that 5% may be deducted only if the contributions do not exceed the unfunded past-service cost as of the beginning of the year plus the normal cost of the plan for the year. *Rev. Rul.* 57-89.

Back salary for unpaid officer not 107 pay; no "statutory" cause. Taxpayer had been employed by a corporation as an officer for the ten years from 1937, when the corporation was formed, through 1947. The corporation was unable to pay him salaries currently, but it was agreed that he would receive an appropriate salary when the company was in a financial position to pay it. In 1949, he received $32,000 for services rendered in the four years from 1941 through 1944, which he reported as Section 107 compensation. The Tax Court held that Section 10(a) was inapplicable because the $32,000, out of a salary of $92,000 authorized in 1948 for the entire period, was not 80% of the total. Furthermore, the payment did not qualify as back pay under Section 107(d); the failure of the corporation to make payment currently was due not to an event specified in Section 107(d)(2) but because the company chose to apply its funds otherwise. This court affirms. *Ward*, CA-6, 1/16/57.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Don't cooperate with IRS agent; reliance on constitutional rights is better tactic

A WARNING THAT cooperating with IRS agents can send your client to jail was recently made by Paul Lipton, Milwaukee attorney and member of the ABA Committee on Procedure on Fraud cases. We have made this point repeatedly in these columns; we take this opportunity to reemphasize its importance, having as we do this very practical comment from a lawyer who has written and lectured extensively on fraud cases. Writing for *Dicta** (a column in the *Virginia Law Weekly*), he said in part:

More taxpayers were investigated, more cases were recommended for prosecution, and more convictions were obtained during the fiscal year ended June 30, 1956 than in any other period in the history of the income tax. The current drive against tax evaders began in 1951 when disclosures of corruption in the administration of the revenue laws threatened to undermine public confidence and increase the incidence of tax evasion. Renewed concern about a possible breakdown of the self-assessment system has been caused recently by severe criticism of the income tax by a former Commissioner of Internal Revenue and other prominent individuals. It is unlikely, therefore, that there will be any letdown in the program of vigorous enforcement against tax evaders. Indeed, the criminal investigative force was recently increased by approximately 25%.

With the increased emphasis on criminal prosecution it is imperative that tax practitioners become familiar with the taxpayer's rights in fraud investigations. Constitutional rights, particularly, have assumed great importance. By and large, however, the profession has been slow in recognizing the importance of effectively protecting the rights of clients under tax investigation. This has been due to insufficient comprehension of the philosophy behind enforcement policies and unfamiliarity with investigative techniques.

Before the abandonment of the "voluntary disclosure" policy on January 10, 1952, conscience-stricken evaders (or those anticipating an investigation) could escape prosecution if they voluntarily disclosed their fraud prior to the initiation of an investigation. Even when an investigation had begun, full cooperation by the taxpayer, together with payment of taxes and penalties, frequently served to avoid prosecution. Notwithstanding the abandonment of the voluntary-disclosure policy, which was occasioned primarily by the belief that the criminal sanctions should serve as a deterrent to evasion, most taxpayers and their representatives still believe that cooperative taxpayers will be permitted to settle their tax liabilities without criminal consequences. As a result, many convictions in tax-evasion cases are obtained solely on information and records voluntarily presented to the investigating agents.

A brief review of investigative procedures and techniques may aid in exposing the pitfalls confronting a taxpayer under investigation. If the examination is a routine matter, it will be conducted by a revenue agent attached to the Audit Division of the District Director's office. If suspicion of fraud exists at the outset, or if evidence of fraud is uncovered by the revenue agent, a Special Agent of the Intelligence Division is assigned to conduct a joint investigation with the revenue agent. It is of particular importance to remember that the primary task of the Special Agent is to uncover evidence which will warrant criminal prosecution.

At times an investigation is commenced in the guise of a routine audit when the Government is already in the possession of information indicating tax evasion. In such instances, the revenue agent's objective is to obtain information and access to records which might not be forthcoming if the taxpayer knows that a criminal investigation is in progress. When the Special Agent does make his appearance, his official capacity is not always made known and rarely is his chief interest—criminal prosecution—disclosed to the taxpayer.

The taxpayer's cooperation is sought in all fraud investigations, often under the pretext that the examination is "informal" and solely for the purpose of determining the tax liability. Ordinarily, taxpayers are not informed of their constitutional rights at the outset of the investigation, or when records are requested or informal questioning is undertaken. If the taxpayer appears for formal questioning under oath, however, he will be warned that the testimony he gives may be used against him in a criminal proceeding.

Taxpayer has no duty to cooperate

Actually, the taxpayer is under no duty to cooperate with investigators whose purpose is the preparation of a criminal charge. He need not answer informal inquiries, and he need not respond to formal questioning under oath when his answers might tend to incriminate him. Notwithstanding the impression to the contrary, the *individual* taxpayer need not produce his private books and records for the investigators. Even though the Code requires that records be kept by taxpayers, the courts have generally held that an individual's income tax records are protected as privileged under the Constitution and need not be made available if self-incriminating. As a matter of fact, although revenue agents will *request* permission to examine an individual's records, they will *not* subpoena the records if criminal prosecution is contemplated.

Recent decisions

Recently, however, the Fourth and Fifth Circuits have indicated that the required-records doctrine, previously applied only to regulatory legislation, may be applicable to records required by the Code. In *Falsone v. United States*, the Fifth Circuit compelled a certified public accountant to produce his client's

**Dicta*, 9 VA. LAW WEEKLY No. 13 (Dec. 13, '56).
[1] 205 F2d 734 (1953).
[2] 222 F2d 84 (4th Cir. 1955).

records notwithstanding the accountant's assertion of the privilege against self-incrimination in behalf of his client. Although the privilege could have been denied on the grounds that it was personal to the client, the court, noting that the Code requires taxpayers to keep records and authorizes inspection thereof, concluded that such records are not protected by the Fifth Amendment. In *Beard v. United States*, the question again arose indirectly, and the court reached the same conclusion. So long as present administrative policies remain in effect, however, lawyers need not hesitate in advising individual clients that they may decline production of their personal records in reliance on their constitutional privilege against self-incrimination.

Without access to the taxpayer's books and records it may be difficult, if not impossible, for the Government to prove that income was understated. Thus, timely reliance upon constitutional rights frequently serves as an effective safeguard against a prosecution recommendation. Of course, the taxpayer must assert his constitutional rights when records are requested. If he fails to do so and voluntarily makes his records available to the investigating agents, he will be deemed to have waived his constitutional rights and the evidence submitted to the agents will be admissible in a subsequent criminal prosecution.

Conclusion

Many lawyers are now becoming aware that cooperation in fraud investigations is generally a trap for the taxpayer. Cooperation rarely helps, and it frequently paves the way for a prosecution recommendation which otherwise might not materialize. Although it is true that reliance upon constitutional rights will make the revenue agents unduly suspicious, it should be apparent that a recommendation for prosecution must be supported by incriminating evidence and will not be based solely upon suspicion. ☆

NEW DECISIONS IN FRAUD & NEGLIGENCE THIS MONTH

Inconsistency between books and net-worth increase justifies ignoring books. Taxpayer operated slot machines and also had interests in other businesses. His wife kept fairly detailed books. The Commissioner ignored them and computed income by increase in net worth. This the Tax Court held proper. "Net-worth is not a method of accounting within the scope and meaning of Section 41 . . .; the net-worth method merely evidences income apparently received. . . . Nor is it banned merely because taxpayer maintains a set of books from which an income can be computed. To the contrary, when there is an inconsistency between the taxpayer's increase in net worth and the income as reflected in his books . . . the net-worth method provides clear and convincing evidence that such books are not trustworthy." However for all but one year the Tax Court held that evidence of fraud was not clear and convincing. For 1947 there was the taxpayer's plea of guilty to a criminal-evasion proceeding. This court affirms. *Gleis*, CA-6, 2/19/57.

Net-worth fraud conviction set aside; likely source not established. In a divided decision, the First Circuit reverses a policeman's conviction for tax evasion. Although his net-worth increase was not satisfactorily explained, the majority holds that a likely source must be proved, i.e., that actual graft or the opportunity for it must be proved. Admissions of income from this source by taxpayer's attorney were, the court holds, insufficient proof without verification by independent evidence. The dissenting judge states that proof that taxpayer was a member of the vice squad is proof of a likely source of unreported income. *Masser*, CA-1, 2/27/57.

Gambler's conviction by net worth upheld. Much of the Government's case was based on computations of taxpayer's net worth. He operated several gambling casinos and testimony indicated the records were not complete. *Percifield*, CA-9, 2/14/57.

Destruction of detailed daily loss sheets by bookie prevents full loss deduction. [*Certiorari denied*]. A bookmaker kept daily sheets detailing each bet accepted. A single "net win" or "net loss" figure computed for each sheet was entered into his permanent record which was used as a basis for preparation of the tax returns. The detailed daily sheets were destroyed. Although the "net win" figures were accepted, the "net loss" figures were disallowed as unsubstantiated. An allowable loss much smaller than that claimed was determined by the Tax Court under the *Cohan* rule. In spite of the destruction of the daily sheets, no intent to evade tax was found. The circuit court affirmed. *Frederika, cert. den.*, 3/4/57.

Net-worth conviction upheld despite loan-from-deceased-friend defense. The court affirms an unreported district court conviction of income tax evasion by a policy wheel operator. Net-worth computations showed a substantial unexplained increase. The defense relied primarily on the claim of loans from a deceased friend to explain the increases. The court holds that the conviction was in accord with the weight of the evidence. *Irving* CA-7, 2/12/57.

Race-track owner's betting income determined despite loss of records. The Commissioner added gambling gains to the reported income of the taxpayer, a racing stable owner and operator of a race-wire service. The Tax Court approves. The taxpayer contended that the winnings in question were bets made for another. Prior to the income tax investigation, the detailed records of these gambling gains had been destroyed by taxpayer. The court holds the Commissioner's computation was reasonable and that the taxpayer did not prove the determination was erroneous. *Wexler*, CA-6, 2/25/57.

No double penalty for not filing estimate. Taxpayer who filed no estimate for 1950 paid both the penalty for substantial underestimation and the penalty for nonfiling. The court holds the penalty for underestimation inapplicable. [The Service has announced that it will not follow these cases; it asserts both penalties. *Ed.*] *Hodgkinson*, DC Cal., 12/18/56.

Criminal conviction upheld; percentage of unreported income irrelevant. Taxpayer cashed ten checks totaling $4,600 from customers and omitted them from income. His criminal conviction is upheld. The issue is whether there was fraud, not whether there was substantial fraud. *Goodrich*, CA-3, 1/22/57.

Attorney guilty of willfully not filing; insolvency no excuse. Taxpayer-attorney

filed his 1953 and 1954 returns in December 1955, and was found guilty of willfully failing to file. In denying his motion for acquittal, the court says that his defense that he had thought payment must accompany the return and that he was insolvent was insufficient. Evidence of late filing of returns for the years 1948 to 1952 was proper to show his state of mind. *Di Silvestro,* DC Pa., 1/11/57.

Corporate officers guilty for false corporate return though others prepared it. The defendants, public loaders at New York City piers, were convicted of tax evasion. This court affirms. The defendants argued that they took no part in the preparation or filing of the false corporate tax return. The court points out that there was evidence that they received substantial unreported income. As they were active corporate officers, the willful filing of false returns may be attributed to them. The court does not pass on the question of the maximum sentence under an indictment charging false filing because the Supreme Court is presently considering the question in the *Costello* case and because the defendants have not yet been imprisoned for one year. Under Code Section 3616(a), the maximum sentence is one year for filing false returns as a misdemeanor, whereas under Section 145(b) there is a five-year felony sentence for wilful intent to evade tax. *Allied Stevedoring Corp.,* CA-2, 2/4/57.

Tax Court erred in upholding net-worth assessment; lack of opening cash unproved. Taxpayer operated three businesses, a restaurant, a bar, and a gambling club. He kept adequate records of the first two but none of the third. Taking this into account and also that taxpayer filed no income tax returns for many years, had substantial personal expenses during the depression, and borrowed money at high rates, the Tax Court found that his claim of cash on hand at the beginning of the year was unworthy of belief, and sustained deficiencies and fraud penalties. The court of appeals reverses. The years were closed unless the Commissioner proved fraud. That he did not do. The evidence as to the taxpayer's opening net worth was insufficient. The revenue agents made no effort to determine what cash the taxpayer had in a safe deposit box at the beginning of the period. To prove fraud, his claim of accumulated funds must be disproved by clear and convincing evidence. *Fairchild,* CA-5, 1/25/57.

Jury grants refund of deficiencies and fraud penalties paid after taxpayer's death. In 1954, three years after taxpayer died, the Commissioner assessed and the estate paid additional taxes, fraud penalties and interest for the years 1942 and 1943 based on net-worth computations and on unexplained bank deposits. The estate sued for refund on the ground that there was no fraud and, in the absence of fraud, the years were closed. The judge charged the jury to consider the opening net worth and the nature of certain bank deposits and, if there had been an understatement of income, whether it was due to fraud. The jury helds that no fraud occurred. *Myers Estate,* DC Ark., 2/13/57.

Jury finds fraud in two of three years; partial refund allowed. Taxpayer sued to recover additional taxes, fraud penalties, and interest paid in 1952 for the years 1942 to 1944 (closed unless there was fraud). The Commissioner's proof was based on net-worth computations. The jury's verdict was for the taxpayer for 1942 but for the Government for 1943 and 1944. *Goebel,* DC ND, 2/15/57.

Understatement by more than 100% of a dentist's income is sufficient proof of fraud. The Tax Court found that taxpayer consistently understated income by more than 100% in each of the taxable years 1941 to 1946 and that the returns were fraudulent. On appeal, the taxpayer argued that understatement of income is not sufficient proof of fraud. The court agrees that mere admission of a deficiency does not sustain the Commissioner's burden of proof of fraud but that in view of other evidence in this case it cannot say that the Tax Court erred in holding that the Commissioner met the burden. *Reherman,* CA-6, 1/2/57.

Penalties upheld in absence of any defense. Though taxpayer contested deficiencies and penalties for failure to file, he failed to reply or to appear. The court upholds the deficiencies and all the penalties, including fraud. *Greene,* TCM 1957-28.

Willful evasion; sole proprietor reported only his drawings. Taxpayer, operator of a steel fabricating plant, incorporated the business on April 1, 1949 and correctly reported his corporate salary on his 1949 return, but reported as his income prior to incorporation only the amounts he withdrew. His records indicated a profit of almost $30,000 more than the reported "wages" for the three months. Denying motions for a new trial and for acquittal after the jury arrived at a guilty verdict, the court holds the admission of the following items as evidence proper: proof of the filing of Schedule C in prior years, the nonfiling of a 1948 return, and unreported income in prior years. *Steele,* DC Pa., 2/6/57.

Penalty improper. The court holds that a penalty for failure to file an estimated income tax return was improper. But the penalty for substantial underestimation was proper. [The facts are not stated. *Ed.*] *Ingram,* DC Ala., 9/10/56.

Alterations and changes in records justify fraud penalty. Although taxpayer had an accountant prepare his tax returns, he directed the accountant to adjust income and deductions as shown by the books for the purpose of preparing the returns. Taxpayer had also made substantial understatements of income by altering and changing figures in his books and records. The fraud penalties are held properly imposed. *Higdon,* TCM 1957-27.

Understatements due to inefficient help; assessments barred by limitation period. A movie-theater operator understated his income for some early years. The understatements, the court holds, resulted from an inadequate bookkeeping system and inefficient clerical help rather than from any fraudulent intent to evade tax. Consequently, the deficiencies are barred by the statute of limitations. *Lea,* TCM 1957-31.

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TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

Masquelette reversed; 5th Circuit allows capital gain on accounting-practice sale

by **M. J. SPORRER**

THE REVERSAL of the Tax Court by the Fifth Circuit in the cases involving the *Estate of F. G. Masquelette* and *E. L. Bruhl*[1] in allowing capital gain treatment under the 1939 Code on the sale of an accountant's practice and holding that a covenant in an agreement not to compete was merely incidental to a sale of goodwill came as a distinct surprise to many tax lawyers and accountants who have heretofore felt that transferable goodwill did not exist in a professional firm.

The questions presented before the Tax Court were (1) whether the proceeds received by petitioners during their taxable year 1948 from the sale of their respective interests in the intangible assets of an accounting business which petitioners operated as a partnership, together with a covenant not to compete, were taxable as ordinary income or as capital gain; and (2) whether the petitioners erred in reporting as ordinary income in 1948 all of the income of the partnership, including fees earned but uncollected as of the date of the transfer of their respective interests, or whether portions of such income should have been treated as being capital gains. The Service treated all amounts received by the taxpayers as ordinary income.

Sale of intangible assets

With respect to the first question, petitioners contended before the Tax Court that the consideration received from the sale of the partnership intangible assets should be taxed as a capital gain because the proceeds represented a sale of a going business, including the goodwill, and that the covenant not to compete was incidental and inseparable from the sale of the goodwill. They relied upon the decisions in *Toledo Newspaper Co.*,[2] *Toledo Blade Co.*,[3] *Ethyl M. Cox*.[4] The court held them distinguishable on the ground that in those cases the covenant not to compete was nonseverable and had only the function of assuring the purchasers the beneficial enjoyment of the goodwill which was transferred.

Respondent contended that the consideration received was taxable as ordinary income because the petitioners retained the goodwill of the firm and the principal item sold by them was the covenant not to compete which was severable from the goodwill.

The Tax Court held that, although a part of the consideration paid for intangibles was for certain enumerated physical assets pertaining to the office, since the agreement omitted any reference to goodwill and a large part of the going business value of the partnership attached to the goodwill that the name "F. G. Masquelette & Company" bore, which name was specifically retained by petitioners, the covenant not to compete was an item separate from the goodwill attaching to the partnership name and that such amount as was paid for the covenant was ordinary income and not income from the sale of a capital asset.

Handling of uncollected fees

The second question was whether uncollected fees at the date of transfer of the respective interests should have been returned as capital gains. Petitioners relied upon *Swiren v. Commissioner*,[5] which involved the sale of an interest in a law partnership and which held that when the partnership and the partners were on a cash basis (as in these cases) the fees billed and uncollected were a portion of the whole partnership interest and subject to capital gain treatment.

The Tax Court rejected petitioners' position and held that the entire distributive shares were taxable as ordinary income.

It quoted from *George F. Johnson*,[6] as follows:

"It is by now well settled that a withdrawing partner is chargeable with ordinary income on his share of the partnership profits, whether currently distributed or not, up to the time of his withdrawal . . . . *This is so notwithstanding that he sells his interest to the continuing partner.*" (Italics supplied by court.)

Petitioners appealed but abandoned the second question before the court of appeals.

As to the first question, the parties in their briefs before the court of appeals conceded that if the payments were made for the goodwill they represented capital gains, whereas if they were for a covenant not to compete they must be taxed as ordinary income.

After outlining the facts and provisions of the agreement in question, the court observed that the withholding by petitioners of the right to use the name F. G. Masquelette & Company was of no intrinsic value to the sellers since they could not use it in the El Paso area either. The court also stated that the agreement not to compete here was one of the means used by petitioners to assure the purchasers that the entire goodwill of the petitioners in El Paso would be effectively conveyed to their successors who would thereafter occupy the same offices, have all the files and working papers of their clients, together with the lease and working tools not valued as tangibles, such as tax services, systems and the like used in their practice.

In reversing the Tax Court, the Fifth Circuit said in part:

". . . we conclude that the stipulations, written contract, and undisputed evidence require a decision that petitioners sold their goodwill and that this was partially effectuated by their agreement not to compete." Citing *The Toledo Newspaper Co., Toledo Blade Co.* and *Aaron Michaels*, 12 TC 17.

The case was "remanded for further

[1] TCM 55-221, Dec. 21, 1955.
[2] 2 TC 794.
[3] 11 TC 1079, aff'd per curiam, 180 F2d 357.
[4] 17 TC 1287.
[5] 183 F2d 656.
[6] 21 TC 733, 738.
[7] Swiren, note 5 supra.
[8] United States v. Snow, 223 F2d 103; Leff v. Comm'r, 223 F2d 439.
[9] USDC, Dist. Del., 2/4/57.

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proceedings not inconsistent with this opinion."

Rule of 1939 Code

The *Masquelette* and *Bruhl* cases involved Section 117 (a) of the 1939 Code, relating to definitions of capital gains and losses, which is similar to Sections 1221 and 1222 of the 1954 Code. However, the 1939 Code contained no provisions as to whether capital gains or ordinary income would result from the sales of partnership interests. Taxpayers had to resort to court action, with the result that conflicts arose. Generally a partnership interest was regarded as being a unit and its sale was accorded capital gain treatment.[7] However, when the sale price took into consideration receivables which were collected by or accrued to a partnership, proceeds attributable thereto were treated as ordinary income.[8]

The problem of taxing receivables under the 1939 Code was again presented in *Tunnell v. United States*,[9] in connection with the sale in 1951 of an interest in a law partnership which, as in *Swiren*, was on a cash basis. However, in the *Tunnell* case the court rejected the rationale of the *Swiren* case and held that partnership income was income to the partners whether distributed or not. It also rejected the contention that income attributable to receivables was not actually realized at the time of sale by a partnership on a cash basis. The court said that "the sale price accelerated realization and replaced the ordinary income, and . . . the method of accounting used by the partnership for reporting purposes is not controlling on this issue."

1954 Code resolves question

This question has now been resolved with respect to 1954 and subsequent years by the enactment of Sections 731(a), 736(b) and 751(a) and (c) of the 1954 Code under which amounts paid for a deceased or retired partner's interest in unrealized receivables shall not be considered to be amounts realized from the sale or exchange of a capital asset.

Section 736 of the 1954 Code introduces specific provisions with respect to the treatment of payments made to a retiring partner or his estate, heir or other successor in interest. It now appears clear that capital gain treatment will be available generally only to the extent that payments are for an interest in partnership property. However, as stated previously, payments for an interest in partnership property does not include amounts paid for unrealized receivables. Nor do they include amounts paid for "substantially appreciated inventory," as this term is defined under Special Rules for "Receivables and Inventories," or goodwill, except to the extent that the partnership agreement provides for payments with respect to goodwill.

The treatment of payments which are not made for an interest in the partnership depends on whether or not these are determined with reference to the income of the partnership or are treated as "guaranteed payments." In either case, they will be taxed as ordinary income and not capital gain.

It is possible that, if the transactions in the *Masquelette* and *Bruhl* cases had occurred in a year governed by the 1954 Code, the court of appeals might have affirmed the Tax Court in holding that all amounts received by Masquelette and Bruhl were ordinary income to them, especially since it appears that the partnership agreement did not contain any provisions with respect to payments to retiring partners for goodwill. Accordingly, these cases may not be a good precedent for similar cases under the 1939 Code involving the question of whether amounts received by retiring partners in payment for their interest in a partnership should be taxed as capital gains or ordinary income. It is very likely that hereafter courts passing on cases under the 1939 Code will be influenced by the provisions of the 1954 Code.

THE FACTS IN THE MASQUELETTE CASE

F. G. Masquelette has been a successful accountant in Houston, Texas, since 1909 and in El Paso since 1912. In 1934 E. L. Bruhl (also petitioner in the other case consolidated with the *Masquelette* case) became the resident partner in the El Paso office of E. L. Masquelette Company and in 1939 a partner in the Houston office, there being two separate partnerships. During 1946, 1947 and 1948, Masquelette and Bruhl spent substantially all of their time in Houston. In 1948, they learned that the other partners in El Paso were dissatisfied with having their work supervised by nonresident associates and were planning to leave Masquelette & Company of El Paso to form a new accounting firm in that city.

They also learned that unless Bruhl moved back to El Paso and devoted most of his time to that office it would thereafter be impossible to maintain a profitable accounting practice in El Paso in competition with Douglass, Oliver, and Hughes, the other El Paso partners, since substantially all of Masquelette's El Paso clients indicated an intention to continue doing business with them should they sever relations with Masquelette and Bruhl.

The sales agreement

A written agreement was entered into: detailing the method of determining the equities of the respective partners in the net tangible assets in the El Paso partnership; stipulating that Masquelette would accept a certain sum "in full satisfaction of their combined interests in the tangible capital of the partnership as of May 1, 1948"; providing for the payment of $24,000 to Masquelette and Bruhl for their combined interests in such intangibles as the right to serve clients within a certain area and including "the right and title to the possession and use of the office quarters being occupied by the terminated partnership . . . to all the files, correspondence, working papers, copies of tax returns and copies of reports, which have been accumulated in the operation of the office, and any leases in connection with such property" but "excluding the right to the use of the trade name of F. G. Masquelette & Company, or any derivative of that name, or any name including either the name of F. G. Masquelette or Edwin L. Bruhl, and with the further consideration that F. G. Masquelette and Edwin L. Bruhl shall refrain from engaging in the practice of public accounting . . . either individually, collectively, or in association with others, directly or indirectly, within the City of El Paso, or its immediate trade territory (defined to include geographical area within a radius of 100 miles of El Paso)"; and also expressly prohibiting "the use by Douglass, Oliver or Hughes of the name F. G. Masquelette & Company or any combination of names using the name Masquelette or Bruhl."

The *Masquelette–Bruhl* cases do emphasize the question of whether or not there is marketable value in goodwill of a professional partnership. It is difficult to understand how the court of appeals could determine that goodwill was transferred in these cases involving a professional accounting practice, particularly since it found as facts that (1) there was a specific agreement against the use of the name under which the partnership had operated for so many years and (2) it would be impossible for Masquelette and Bruhl to maintain a profitable accounting practice in El Paso in competition with the other partners. ☆

How to avoid the taxation of limited partnerships as corporations

by **JOHN G. HEARD**

That the Service may label a limited partnership as a corporation is a threat that must be considered in organizing and operating this kind of organization. The steps that can be taken to safeguard against such labeling and to obtain the maximum tax benefits inherent in limited partnerships are here enumerated by the author, an attorney and CPA with the Houston, Texas, law firm of Vinson, Elkins, Weems and Searls.

THE 1954 CODE continues the 1939 Code definition of partnership. It says that "the term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not within the meaning of this title, a corporation or a trust or estate."[a]

The Regulations under the 1939 Code stated: "The Uniform Limited Partnership Act has been adopted in several states. A limited partnership organized under the provisions of that Act may be either an association or a partnership depending upon whether or not in the particular case the essential characteristics of an association exist."[b] Accordingly, every limited partnership under the uniform law must be examined to see if it has the requisite characteristics of an association. If it does not have such characteristics, then it is a partnership for tax purposes.

What is an "association"

The association question is an old problem. Primarily from case law it has been developed that an association is taxable as a corporation where (1) there are associates, (2) the object is to carry on a business and divide the gains therefrom, (3) provision is made for centralized control of management through representatives of the participants, and (4) the management has continuity.

As can be readily seen, the first two characteristics listed above, associates and joint profits, are as inherent in the limited partnership as in a corporation.

The Service likewise recognized this; in the Regulations under the 1939 Code it stated, in effect, that in the absence of either the third or fourth corporate characteristics listed above, a limited partnership would not be taxable as an association. That provision of the old Regulations states: "A limited partnership is classified for the purpose of the Internal Revenue Code as an ordinary partnership, or, on the other hand, as an association taxable as a corporation, depending upon its character in certain material respects. If the organization is not interrupted by the death of a general partner or by a change in the ownership of his participating interest, and if the management of its affairs is centralized in one or more persons acting in a representative capacity, it is taxable as a corporation. For want of these essential characteristics, a limited partnership is to be considered as an ordinary partnership notwithstanding other characteristics conferred upon it by local law."[1]

The genesis of the present approach of the Service to the association problem in its particular application to limited partnerships seems to be a dictum of Judge Kern of the Tax Court in *Glensder Textile Co.*[2] In that case it was held that a limited partnership organized under the Uniform Partnership Law of New York was a partnership for tax purposes rather than an association. However, the importance of the case is not its holding but rather the following statement: "Even within the form of limited partnership most generally known, in which general and limited partners are associated together, we may still suppose situations where the resemblance to corporate form would be so substantial as to justify classification of the limited partnerships as corporations. If, for instance, the general partners were not men with substantial assets risked in the business, but were mere dummies without real means acting as the agents of the limited partners, whose investments made possible the business, there would be something approaching the corporate form of stockholders and directors. But, as a practical matter, to suppose such a situation we must also suppose that the limited partners were, in reality, not merely silent partners without control of affairs but were empowered to direct the business actively through the general partners. We suggest this possibility merely to show that designating a partnership as of a particular kind involves no more than applying a particular name, and that the really vital thing, the rights and duties of the partners as between themselves and the public, may vary as much as the legislatures of the several states may think fit to allow."

From this language there have been drawn two concepts. First, general partners must have substantial assets risked in the business or else they may be considered only dummies acting as agents for the limited-partner investors; second, limited partners must not be placed in the position of directing the business of the partnership by restrictions in the limited-partnership agreement on the rights of the general partners to control the business.

Abetted by this language the Service for some time required that a general partner actually make a substantial contribution to the capital of the partnership. Apparently, the Service has now abandoned this approach and has recognized in private Rulings that a general partner can contribute *only services* and the organization still qualify as a partnership for tax purposes. There is certainly an economic effect when a person

[a] Section 761. See also Sec. 7701(a)(2).
[b] Reg. 118, Sec. 39.3797-5(b).
[1] Reg. 118, Sec. 39.3797-5(a).
[2] 46 BTA 176, a cq. 1942-1 CB 8.
[3] Uniform Partnership Act, Sec. 9(a).

of substantial personal means subjects his personal wealth to the liabilities of the partnership by becoming a general partner therein.

However, the second concept has retained its vitality and care should be taken to grant the general partners such wide powers that the Government cannot contend that the limited partners actually control the partnership business by virtue of restrictions in the agreement upon the general partners. In other words, in a limited partnership the characteristic of centralized management should be *cultivated* rather than avoided to the extent that the general partners have effective business control of the enterprise, to the exclusion of the limited partners.

Centralized management

The rights and powers which may be given general partners under the uniform act may well be the equivalent of the third corporate characteristic, that of centralization of management. In fact, to retain his status under the uniform act the limited partner must not take part in the control of the business. The uniform act endows the general partner with all the rights and powers of a common-law partner and likewise makes him subject to all the restrictions and limitations of the partner in a general partnership, except that without the written consent of all limited partners, the general partner has no authority to:

1. do any act in contravention of the certificate,
2. do any act which would make it impossible to carry on the ordinary business of the partnership,
3. confess a judgment against the partnership,
4. possess partnership property, or assign their rights in specific partnership property, for other than a partnership purpose,
5. admit a person as a general partner,
6. admit a person as a limited partner, unless the right so to do is given in the certificate,
7. continue the business with partnership property on the death, retirement or insanity of a general partner, unless the right so to do is given in the certificate.[3]

To avoid the assertion that the limited partners are controlling the partnership through restrictions on the general partners, it would seem advisable to draft the partnership agreement in such a manner that the general partner has the most complete, unrestricted control of the business. The statutory limitations of the uniform act on the power of the general partner, as listed above, do not appear to restrict the centralization of management in the general partner to any great extent from a practical standpoint. With only these statutory restrictions to hamper him, there seems to be little doubt that the partnership has centralization of management in the general partner.

Continuity

The fourth characteristic of the association status, continuity of life, is the one most widely used to prevent the corporate stigma. Under the uniform act the retirement, death or insanity of a general partner will not dissolve the limited partnership, if the remaining general partners continue the business under the authority granted in the certificate of limited partnership or with the consent of all the partners. If the certificate grants such right to the remaining general partners, there is little doubt but that the Service would contend that this is sufficient continuity of life to classify the partnership as an association.

In an interesting recent ruling the Service considered a situation where all continuing partners must *consent to continue* and stated:

"Where continuation of a limited partnership is contingent upon the consent of all the continuing partners it does not follow . . . that such partnership has the continuity of life that is characteristic of and is taxable as a corporation for Federal income and employment tax purposes. Continuity of life in the corporate sense, a requisite of an association taxable as a corporation, is not practically attained by provisions in a partnership agreement making it possible for the continuing members to continue the partnership if they choose." To assure partnership status, the limited-partnership agreement should be drafted to provide for partnership dissolution upon retirement, death, or insanity of a general partner.

Termination of limited partnership

Neither the retirement, insanity or death of any of the limited partners will terminate the partnership unless the agreement so specifies. The uniform act provides that on the death of a limited partner his executor or administrator shall have all the rights of a limited partner for the purpose of settling his estate, and such power as the deceased limited partner had to constitute his assignee a substitute limited partner. With respect to the retirement, insanity or death of a general partner, we have already discussed the possibility of having the limited-partnership agreement drawn to dissolve the partnership upon either of those events to avoid the association classification for tax purposes. The fact that the surviving general and limited partners agreed at that time to continue the partnership business, as they can do under the uniform act, should not endanger them from the continuity-of-life test for association status.

The formalities of cancellation of the certificate of limited partnership on file with the designated state office are set forth in the statutes. These provide generally that the certificate shall be canceled when the limited partnership is dissolved, or when all limited partners cease to be such. The instrument to cancel the certificate shall be signed by all partners.

There are other matters which should be considered in the determination to use the limited partnership form of business organization. First, the partners become subject to all of the partnership rules of Subchapter K, if the partnership is recognized as such for tax purposes. This includes the limitation that a partner's distributive share of a partnership's loss can be deducted for tax purposes only to the extent of his adjusted basis in his partnership interest. Further, as a general rule the interest of a partner in a limited partnership may be much less salable than an undivided interest in properties owned by the partnership. The same is true in borrowing against a limited-partnership interest on the one hand and against an undivided

OTHER PAPERS IN THIS SERIES

THE ACCOMPANYING article is drawn from a paper written by Mr. Heard for the Third Annual Institute on Taxation conducted by the Texas Society of CPAs and the University of Houston. Mr. Heard's paper in its entirety, plus 13 other papers by leading tax men, is being published this month by THE JOURNAL OF TAXATION in book form. For details, see advertisement on inside front cover of this issue.

interest in mineral or other properties on the other. Also, separate partnership records must be maintained, and prescribed partnership returns must be filed in accordance with the Revenue Code and the Regulations. ☆

New partnership decisions this month

Family joint venture found valid. Taxpayer and two others bought some $23,000 worth of surplus bomb hoists. Taxpayer, his two sons, and son-in-law were to share in an undivided one-third interest. This arrangement, though informal, was found by the Tax Court to be valid. The Tax Court stated that the Commissioner erred in including the sons' and son-in-law's shares of the profits in taxpayer's income. This court affirms. *Zack,* CA-6, 2/19/57.

Patent exploitation was joint venture; profits taxable despite dispute over payment. Taxpayer-corporation, organized to exploit a patented portable flame thrower, agreed in 1942 to make the patent available to a manufacturing corporation for its use in manufacturing and selling the device to the Government. Taxpayer was to make available the engineering services of its principal officer, the inventor, while the manufacturer was to have exclusive supervision and control over the necessary finances, plant facilities, sales and production activities, and all management functions. Profits and losses were to be shared equally at the completion of the war. A dispute arose as to the time an accounting and distribution of profits should be made. This was settled in litigation in 1951. The court now holds taxpayer was a joint venturer, and was not in a master-servant relationship. As a joint venturer, taxpayer was required to include in its gross income during 1944 and 1945 its distributive share of the joint-venture profits even though distribution was delayed until 1951. Furthermore, its failure to file excess profits tax returns for 1944 and 1945 because of lack of knowledge of its share of the profits is considered not due to reasonable cause, and penalties are sustained. *Beck Chemical Equipment Corp.* 27 TC No. 103.

Partnership liquidation not a 751 sale of unrealized items. The 1954 Code provides in Section 751 specific rules for the taxation of a partnership's unrealized receivables or substantially appreciated inventory upon distribution to a partner for his interest in other partnership property. In effect, this is treated as a sale by the partnership and the realization is ordinary income. However, a distribution in kind by a partnership in liquidation to a partner of his proportionate share of inventory items which have appreciated substantially in value does not constitute a sale or exchange of such assets within the meaning of Section 751. The distribution in liquidation is not in exchange for the partner's interest in other partnership property, as specified in Section 751. This distribution is covered by Section 731, providing that no gain is recognized except to the extent that money exceeds the partner's basis. *Rev. Rul.* 57-68.

Jury finds oral partnership valid. Taxpayer claimed that during 1941 to 1943 (the years in question) he and his relatives were partners in a business carried on in his name, though a formal agreement was not drawn up until 1942. Very few facts are reported. The jury finds for taxpayer. *Biles,* DC Okla.

Unfinished contracts purchased by surviving partner entitled to an allocated-cost basis. One of two partners of an architectural firm purchased his retiring partner's interest and thereafter continued the operation of the business as a sole proprietorship. They had fixed the purchase price by estimating the profits to be derived from certain contracts transferred. The court holds that the surviving partner is entitled to a basis equal to an allocated part of the purchase price in computing the gain realized upon their completion by him as a sole proprietor. He purchased contracts, not a partnership interest, and unlike goodwill or customers lists, the contracts would have no value after completion. *Silling, Sr.,* 27 TC No. 79.

Allocation of expense among partners approved. A construction partnership of taxpayer and two others reconstructed a garage apartment, title to which had been transferred to taxpayer's wife. The costs were charged to the other two partners. One of the partners, who was charged with the major share of the costs, lived in the apartment. The court concluded the expenditures did not represent income to taxpayer. However an unexplained payment to taxpayer's wife by the partner occupying the apartment is held includible in the wife's income. *O'Shea,* TCM 1957-15; *Finley,* TCM 1957-16.

Partner's wife became limited partner at his death. Taxpayer's husband died in 1946, and pursuant to agreement taxpayer continued to receive payments from his partnership. The court holds that taxpayer became a limited partner in the partnership at her husband's death and that she must therefore include in her income her distributive share of partnership profits for that year. Conversely, the court holds that the partnership properly credited taxpayer with the full amount of her distributive share on the partnership return even though she was not actually paid that much. *Laube,* TCM 1957-13.

Partnership omitted credit sales; five-year limitation period applied to partners. A partnership which sold and repaired electrical appliances omitted credit sales from the computation of its gross receipts. The court notes the omitted income was in excess of 25% of what the partner reported; this figure is arrived at whether the computation is made in terms of partnership gross or partnership net allocable to taxpayer. *Iverson Estate,* 27 TC No. 196.

Section 3801 relief granted for a barred year deduction erroneously taken in open year. An accrual-basis taxpayer deducted in 1953, the year of payment, a property tax which had accrued in 1952. An adjustment of 1952 (otherwise closed) is permitted under Section 3801 of the 1939 Code. *Rev. Rul.* 57-13.

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THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

Tax advantage in split-dollar insurance more certain than bank-loan method of financing

TWO OF THE currently popular insurance plans whose usefulness depends to a great extent on the tax advantages inherent in them are split-dollar insurance and the bank-loan method of financing insurance policies. Troy N. Whitehurst, a chartered life underwriter associated with the C & I Life Insurance Company, Houston, recently compared the two during the course of his talk at the Third Annual Institute of Taxation conducted by the Texas Society of CPAs. at the University of Houston. This is what he said:

Bank-loan plans

A new and controversial way of carrying life insurance is the bank-loan method. The National Association of Life Underwriters has gone on record in opposition. Some of our large companies say they would not issue insurance if they knew it was to be maintained by this method, but are unable to detect the method at time of issuance. Other companies are actively soliciting such business. And, during past months, a tremendous volume of insurance sales has resulted from this approach.

There are almost as many variations of the bank-loan plan as there are agents selling it. But the basic idea is the same and is simple. It has to do with borrowing money to pay premiums and deducting interest paid from income for tax purposes. Since the annual improvement in insurance values, and dividends received from participating policies, are not reportable, the plan seems to result in low protection cost for the taxpayer in higher brackets.

But those who have gone on record as opposing such a plan point out that it was not too many years ago that interest on amounts borrowed to purchase or maintain a single-premium life-insurance policy was deductible, and, until March 1, 1954, such interest was deductible if the contract was a single-premium annuity. It is at least possible that deductions will be disallowed at some time in the future for interest paid on funds borrowed to maintain annual-premium policies.

Any change in the law which makes taxable the annual increase in policy values, or the dividends from participating policies, would decrease the attractiveness of the loan plan. So, too, would any decrease in life-insurance policy dividends.

Adoption of the loan plan destroys the safety factor of cash value built into all permanent life-insurance policies. After a few premiums have been paid, the cash value can be used to take care of the situation for at least a short period if the insured suffers financial reverses. This is not true under the loan plan. The interest and net premium, if any, must be paid or the protection lapses.

The insured who adopts the loan plan must be interested solely in insurance as death protection and he must be willing to accept a reducing amount of such protection, at least during the premium-payment period.

The insured who adopts the loan plan should be able and willing to pay off the loan out of other assets, if: (a) there is a change in the Federal tax law which makes the plan unattractive; (b) his taxable income or applicable rates thereon decrease materially; or (c) insurance-company dividends are terminated or reduced substantially.

Some agents propose the loan plan with the entire premium, rather than merely the insurance cash value, being borrowed at all times. This involves additional credit or collateral aside from that supplied by the insurance itself. Again, we still find proposals with a 3½% interest assumption. Most banks started charging higher interest rates than 3½% some time ago.

Split-dollar insurance

For several years one of the tax services has advocated use of the split-dollar plan, having adopted it for its own executives. But it was Rev. Rul. 55-173, issued December 5, 1955, that sparked the interest of businessmen generally.

The split-dollar plan is simple. Usually the insured is a key employee. The employer helps the employee buy insurance on his own life by "splitting" the cost with him. Each year the employer pays a portion of the premium equal to that year's increase in the cash value of the policy. The employee pays the balance, if any, of the net premium. Upon the insured's death, proceeds equal to the cash value (the employer's investment) are paid to the employer; the balance of the proceeds are paid to the beneficiary named by the employee. Should the employee leave, the employer recovers its investment either by surrendering the policy for its cash value or by permitting the insured to purchase the policy for that amount. Under this plan of purchase:

1. The employee can buy more insurance than he would otherwise be able to own, at a time when he needs it most. The amount usually exceeds by a substantial figure that available under a group plan.

2. The employer can give the employee the equivalent of a tax-free salary increase, thus helping induce him to stay with the company. The cost to the employer is the interest lost on funds so invested. It should be recognized at the start that the employer's investment will reach a substantial figure in the later policy years. The cash value of an ordinary-life policy at age 65, issued at any age below about age 40, will exceed 50% of the face amount. One employer, with several such employees insured for substantial amounts, is not willing to "freeze" the required investment. He borrows the cash value at all times, with the policies pledged as collateral. Here we have a combination of the split-dollar and bank-loan ideas.

By combining the split-dollar principle with the relief from the transfer-for-value rule contained in Section 101(a)-(2)(B) of the Code, we can help the policyholder who is in financial distress. The Section referred to provides that the

rule for taxing the gain under a life-insurance contract transferred for value shall not apply if such transfer is to a corporation in which the insured is a shareholder or officer. (A similar exception applies if insurance is transferred to the insured, to a partner of the insured, or to a partnership in which the insured is a partner.)

Take the case of the president of a corporation, owning some 60% of the outstanding stock, whose salary has been kept too low and whose income has been supplemented by large dividends paid by the corporation year after year. The year 1955 was a poor one for the corporation. Dividend payments were suspended. The president found himself with a personal debt load and with personal life insurance requiring annual premiums of $5,200. His load was impossibly heavy. The corporation owned insurance on his life requiring annual premiums of $5,800. By selling a large part of his personal insurance to the corporation for its cash value and working out split-dollar arrangements with respect to it and to some of the original corporate insurance, the following were accomplished:

1. The president received as tax-free sales proceeds the cash value of some $20,000 with which to help retire personal debt.

2. His premium load was reduced from $5,200 to $2,500. (Corporate premium requirements increased by a like amount.)

3. Both personal and corporate death protection were unchanged during the current year. As the corporation pays future premiums, however, the corporate protection will increase by about $2,700 per year. Assuming an improvement in his personal financial position, if he wants to reacquire some or all of the insurance in the future, apparently favorable action by the board of directors will be all that is required.

This same corporate president found Section 105 of the 1954 Code helpful. By transferring accident-and-sickness policies paying $100 of weekly indemnity to the corporation, he was able to reduce his personal annual premium requirements by another $300.

The Revenue Ruling (55-173) which lit the fuse for split-dollar cases contains these words: "the insurance arrangement between the parties is in all essential respects the same as if [the employer] makes annual loans without interest, of a sum of money equal to the annual increases in the cash-surrender value of the policies of insurance taken out on the life of . . . [the employee]. The mere making available of money does not result in realized income to the payee or a deduction to the payor."

The question has been raised as to whether such a "loan" to a stockholder-employee might be regarded as a dividend and hence taxable. So far as I know the question has not had a formal answer. Informal inquiries lead to the conviction that the use of the policy cash value as collateral to insure the repayment of the "loan" will almost automatically insure against the "loans" being regarded as a dividend. Despite this, there is the fear that under certain circumstances, such as a corporation entering into a split-dollar arrangement with an employee who owns 100% of the corporate stock, normal interest sacrificed by the corporation on the amount it invests might be regarded as a dividend to the stockholder-employee. The fact that he receives an "economic benefit" because of the arrangement cannot be disputed. ☆

Tax men should support bills granting retirement benefits, now being considered

by **SAMUEL TAYLOR**

The Jenkins-Keogh bills, which have been kicking around Congress for six years, are once again alive. Mr. Taylor, a San Francisco lawyer, feels that lawyers and accountants, along with other professional people, ought to give them their full support. His dollar-for-dollar comparisons bring out clearly the extent of the discrimination against the self-employed, should aid the early passage of the legislation which will eradicate it

OF GREAT FINANCIAL INTEREST to lawyers, doctors, dentists, and other self-employed persons are the so-called Jenkins-Keogh bills now pending before Congress. They seek to extend to self-employed persons and to employees not now covered the same favorable tax advantages presently enjoyed only by employees covered by qualified pension and profit-sharing plans contributed to by their employers.

Under the Internal Revenue Code, an employer who desires to provide retirement benefits for his employees may establish and have approved by the Treasury Department a pension or profit-sharing plan. The amounts contributed by the employer to such plan are deductible. The earnings on the accumulated contributions are tax-exempt. The employees are not taxed until they actually receive payments under the plan. Upon retirement, the employee may elect to receive his share of the accumulated contributions in installments over a period of years, or in a lump sum. If he elects an installment plan, the payments are taxed as ordinary income. If he elects payment in a lump sum, it is taxed at long-term capital-gains rates. On the death of the employee, up to $5,000 of the distribution from the plan is exempt from income tax. In addition, on death the value of the employee's interest under the plan payable to any beneficiary (other than his executor) is wholly exempt from federal estate tax.

That the special treatment accorded to qualified pension and profit-sharing plans is of real and substantial monetary benefit to employers and employees is attested to by the tremendous growth of such plans over the past few years. According to Internal Revenue Service statistics, the total number of qualified pension and profit-sharing plans mushroomed from some 110 plans in 1930 to 26,573 plans as of December 31, 1954. Official figures are not available to show the total amount of dollars contributed to pension plans by employers in recent years, but some idea of the total amount of funds involved may be had from the statistics that were released by the New York Superintendent of Banks, which show that at the end of September, 1955, pension and other employee-welfare funds held by New York banks alone totaled almost $7.5 billion.

Under present tax laws, only "employees" are eligible for qualified pension and profit-sharing plans. Self-em-

ployed persons are denied the favorable tax-relief provisions granted to employees. They must provide for their retirement out of after-tax dollars rather than out of before-tax dollars as do employees under qualified plans. This difference in tax treatment results in unfair and unjustified tax discrimination against the self-employed, and in favor of employed persons.[1]

To best illustrate how sharply the taxing statutes discriminate against self-employed persons, let us compare the retirement situation of lawyer A, who is engaged in private law practice, with lawyer B, who is employed by a corporation having a qualified pension plan. That the discrimination applies equally to those in low income tax brackets as well as to those in high income brackets readily appears from the following two illustrations:[2]

Taxpayers in lowest surtax bracket

Let us assume that both A and B, and their wives, are age 40. They earn total incomes of $4,600 annually, have no other source of income, and each is able to save $400 a year for retirement. In B's case, only $4,200 of his income is paid to him directly—the other $400 is deposited by his employer to B's account in the company pension trust. Assume that A invests his savings in a bank returning 2½% interest and B's funds in the trust also earn 2½%. A projected comparison of A's and B's retirement situations would look like this:

Of course, B's dollars are still potentially subject to tax since the pension plan merely postpones the tax. Under the law, B can elect to receive his pension account in a lump sum and pay capital-gains rates, or in installment payments which are taxed as ordinary income. Suppose that B retires on January 1st at age 65 and withdraws his account in a lump sum. To make the problem more realistic, let's also assume B and his wife have $1,000 of other taxable income.

EXAMPLES OF ADVANTAGES OF JENKINS-KEOGH PLAN

	Lawyer A No pension plan	*Lawyer B With pension plan*
Gross annual savings	$ 400	$ 400
Less tax (assumes 20% tax rate)	80	None
Net annual amount available for investment	320	400
Gross annual earnings on investments	2½%	2½%
Less tax on investment earnings (assumes 20% rate)	½%	None
Net annual earnings on investments	2%	2½%
Gross amount accumulated at age: 50	$ 3,574	$ 4,593
60	7,930	10,473
65	10,455	14,005

At age 65, the foregoing computation discloses that B will have accumulated approximately 34% more than A, although both saved equal amounts each year.

With four exemptions (B and his wife are both over 65), B would pay slightly less than $1,000 in tax receipt of the $14,005. In short, by taking his account as a lump sum, B would end up with slightly over $13,000 net as compared with A's $10,455, a difference of more than $2,500. The inequity is compounded when it is remembered that upon retirement B and his wife will also be entitled to receive $162.80 monthly social-security payments, which are tax-exempt.

The story does not end here. It is even more advantageous to B to receive his account in installments rather than in a lump sum. At 1956 tax rates, with their four exemptions, B and his wife can earn a little over $220 per month without incurring any tax liability. This means that B can withdraw up to $2,675 annually from the pension fund without paying any tax, assuming that he has no other taxable earned income.

Thus, as a result of pension-plan tax advantages, B can accumulate about $2,500 more than A if he elects to receive his retirement payments in a lump sum, or more than $3,550 if he takes his pension payments in installments over a period of years. Expressed another way, lawyer A must save roughly $4 for every $3 lawyer B saves if both are to end up with the same retirement pension.

Taxpayers in higher surtax brackets

It is perfectly obvious that the higher up on the income-tax scale the employee is, the greater the benefit to be gained from membership in a qualified plan, and the greater is the discrimination against ineligible self-employed persons. Suppose the same two lawyers A and B earn $28,000 annually instead of $4,600 and both are able to save $3,000 annually for retirement. As before, instead of receiving his full salary directly, B's employer deposits $3,000 of B's salary into a company pension plan. Let's assume earning of 5% on the amounts set aside by both A and B. At age 65, we find that lawyer A will have accumulated $67,595 tax-paid dollars, while lawyer B, through pension-plan tax advantages, will have accumulated $150,339 before-tax dollars. If we assume that B elects to receive his pension in a lump sum, he will only have to pay a capital-gains tax of 25%. Thus after taxes, B will have $112,754, as compared with A's $67,595, or roughly 67% more than A. There is the further possibility that B can better his position by electing installment payments instead of a lump sum. Again, the fact that B is eligible for tax-exempt social-security payments further magnifies the disparity between A's and B's retirement funds.

The comparison of the total amounts accumulated upon retirement by the lawyers A and B receiving the same annual income vividly points up the unfair treatment accorded to self-employed persons. No reason exists for this significant difference in tax treatment. The very same arguments which prompted Congress to grant the tax subsidy to employees apply with equal force to self-employed persons, and with even greater force in the case of lawyers and certain other professional groups. The employed and self-employed suffer alike from the same high rates and high cost of living. Without the benefit of special tax treatment, self-employed persons find it almost impossible to accumulate out of current income sufficient funds for old age and retirement. The plight of the professional groups is even more desperate. In addition to regular college education, the average professional man spends from three to eight

[1] Employed persons also enjoy favorable stock option and accident and health benefits which are not available to self-employed persons. For an excellent discussion of the various Internal Revenue Code provisions which discriminate against the self-employed, see Silverson, "Taxation and the Self-Employed: A Study in Retrogression," 41 *A.B.A.J.* 50 (January 1955).

[2] The illustrations contained herein are based upon the examples and mathematical computations found in Zischke, "Tax Factors and Related Business Considerations in Establishing Profit-Sharing Plans," P-H Tax Ideas ¶ 7024.

[3] It is important to remember that a large majority of employed persons are not now covered under employee pension plans either because employers are financially unable or do not desire to set up qualified plans. The Jenkins-Keogh bills would permit this large group to receive the same benefits now accruing to employees participating in qualified plans.

years preparing for his profession. His training is costly and the tax laws do not permit him to amortize its cost over his productive years. Since he starts late in life and must spend several years building a reputation and practice, most of his life-time earnings are bunched into a relatively few peak years. Due to the combined effect of steep progressive tax rates and the annual system of accounting for tax purposes, he pays out a far greater percentage of his earnings as taxes than does the average employed person.

What would the bills do?

Granted that the self-employed should be treated exactly the same as employees, how will this purpose be accomplished by the Jenkins-Keogh bills?

Deductions from earned income. Fundamentally, the bills would allow any self-employed person or employee not eligible to participate in a qualified pension or profit-sharing plan to deduct from gross income each year an amount up to $7,500, or 10% of his earned net income, whichever is less, provided that the amount deducted is paid into a restricted retirement fund or used to purchase a restricted retirement annuity contract.[3]

There is a five-year carryover of the unused annual deductions, with a total lifetime deduction limit of $150,000. A special provision allows individuals who are over the age of 55 at the time the bill goes into effect to build up an adequate retirement fund by excluding additional amounts each year measured by the number of years of their age in excess of 55.

Restricted nature of retirement fund. Whether the taxpayer uses a retirement fund or an annuity contract, he cannot have access to the deposited fund before reaching age 65, unless he becomes totally and permanently disabled. Although he cannot assign his interest, he has the right to designate his spouse or other dependents as survivors or joint and survivor annuitants under any annuity contract which he may receive from his contributions.

Tax treatment. As in the case of qualified employee plans, no income tax would be imposed on the earnings from amounts deposited into the retirement fund. Likewise, the self-employed person would pay no tax until he actually receives retirement payments upon reaching the age of 65 or becomes disabled. If he elects to receive the entire amount deposited in a lump sum after it has been accumulated for more than five years, he receives the benefit of long-term capital-gains rates.

It is important to bear in mind that the Jenkins-Keogh proposal is not legislation of a very few seeking special tax treatment. It is estimated that some ten million persons will be affected by the proposed legislation. This vast segment of our working population is made up of small business men, doctors, lawyers, architects, accountants, brokers, farmers, singers, writers, and the like, in addition to those employees not already eligible under qualified pension plans. They do not ask special tax favors but ask only for equity of treatment in providing for their old age and retirement.

The major argument advanced against the Jenkins-Keogh bills is the fear that it will result in considerable loss of revenue. Any estimates as to the amount of loss are purely speculative, since there are too many variables which are completely unpredictable. Many eligible individuals will not desire to be able to take advantage of the privilege offered by the bills. People not only differ in their ability to save, but many will be deterred from seting up pension plans by the fact that the contributions are placed beyond their reach until after age 65. Some individuals may well prefer to invest their dollars after taxes in securities of their own choice rather than look to the low income yield offered by retirement fund investments. But even assuming that the revenue loss will be great, certainly it is more equitable to distribute the tax burden equally among all taxpayers rather than continue to discriminate against one portion of our working population.

Chances of passage

The Jenkins-Keogh proposal to amend the Internal Revenue Code to permit the creation of individual pension plans is not a new one. Bills with the same general objective have been introduced in Congress in previous years. While none of these bills met with success, the prospects for enactment of the present bills are very favorable. Unlike prior bills which died in committee, the Jenkins-Keogh bills on July 19, 1955, were approved by the House Ways and Means Committee by a vote of 16 to 8. Congress adjourned in August before the bills reached a vote on the floor of the House. They were taken up again during the last session of Congress as a part of an omnibus bill amending the Internal Revenue Code, and were reintroduced in the present session.

The bills have received active support from a wide variety of national, professional, and trade associations, such as the American Bar Association, the National Conference of Bar Presidents, the American Medical Association, the American Dental Association and the Engineering Association. The State Bar of California has endorsed the bills. In addition to bipartisan backing in Congress, the Jenkins-Keogh proposal has President Eisenhower's approval in principle. On October 24, 1952, he said:

"In 1942 the government made an important supplement to the Social Security Act by legislation which offered tax advantages to corporations and their employees in the establishment of pension funds (Section 165 of the Internal Revenue Code). I am thoroughly in accord with the principle of this legislation. Over 16,000 pension plans have been filed under this law providing more adequate security for the employees of corporations covered thereby. When this legislation was being considered, self-employed individuals were evidently forgotten. Yet they get old and sick just as other people do. There are over 10 million workers who can not take advantage of these tax-relief provisions now offered to corporations and their employees. They include owners of small

BRITAIN PASSES BILLS AUTHORIZING PENSION OF THE SELF-EMPLOYED

GREAT BRITAIN has passed legislation allowing self-employed persons and employees not covered by pension arrangements to deduct a proportion of their earnings for pensions. The aim is the same as that of the American Jenkins-Keogh bills, but apparently Britain was less concerned about the potential revenue loss, cared for justice more.

The maximum yearly deduction permitted is about 10% or $1,400, whichever is lower. Carryovers are permitted for maximums which couldn't be used because of inadequate earnings. The annuity contract must be with an insurance company; must provide only for annuity payments; can't pay out until the age of 60 except with special dispensation. ☆

businesses, doctors, lawyers, architects, accountants, farmers, artists, singers, writers—independent people of every kind and description but who are not regularly employed by a corporation. I think something ought to be done to help these people to help themselves by allowing a reasonable tax deduction for money put aside by them for their own savings. This would encourage and assist them to provide their own funds for their old age and retirement. . . ."

It is hoped that those individuals affected by the Jenkins-Keogh bills will take sufficient interest in the proposed legislation to let members of Congress know how they stand on the issue of equal pension rights for all taxpayers. ☆ [*From the Journal of the State Bar of California.*]

New Ruling points way for deductibility of cost of cemetery plot and maintenance

CHURCHES, SYNAGOGUES and other exempt organizations operating cemeteries may be overlooking a possible tax benefit for their members. Payments for perpetual or seasonal care can be made tax deductible. A recent Special Ruling shows how, and Jerome C. Bachrach, Pittsburgh CPA and LLB, comments in that Ruling as follows.

What the Code says

Section 170(c)(5) permits charitable deductions for payments to "a cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation . . ." On October 20, 1955 the Service issued a Special Ruling[1] stating that payments for perpetual or seasonal care of a cemetery lot, and even any part of the purchase price of a lot allocated to such purposes, can be considered a charitable contribution. To qualify, such payments have to be placed in a trust by a company or corporation qualifying as tax-exempt under Section 501 (c)(13).

It will be noted that the Code and Regulations distinguish between a cemetery *company* and a cemetery *corporation*. Apparently, no separate legal status for the cemetery is required under state law. The Service has informally indicated that a cemetery *fund* maintained by a church or a synagogue may qualify if the fund has established its own exemption under Section 501(c)(13). It would be necessary for the religious organization to file Form 1026 accompanied by financial statements of the cemetery fund, a declaration of trust or other document setting forth the fund's aims and purposes, and a copy of its bylaws or other rules of operation. This accomplished, lot-holders would be entitled to the tax advantage of being able to deduct a considerable portion, if not all, of the price paid for their lots, plus their annual maintenance costs.

It appears that this Ruling was in response to a request by a cemetery exempt under Section 501 for advice about the deductibility of (1) payments by a lot owner for perpetual or seasonal care of his lot and (2) a portion of the purchase price of a lot paid over to a Permanent Care Fund used for the upkeep of the entire cemetery. The Revenue Service held that payments made by a lot owner for the purpose of providing perpetual or seasonal care of his lot, and that part of the purchase price of a lot which is paid into the Permanent Care Fund or Current Maintenance Fund, which funds are irrevocably dedicated to the perpetual or seasonal care of a particular lot, or for the upkeep of the entire cemetery, and which are administered by it, *are deductible by the donors in computing their taxable income* in the manner and to the extent provided by Section 170 of the 1954 Code." ☆

[1] October 20, 1955, as reported in 5 CCH 1956 FED. TAX REP. ¶6102.

New decisions

Periodic payments to wife living apart from husband taxable as alimony. Taxpayer, living separate and apart from her husband, received $300 per month pursuant to a final decree of separate maintenance. She contended that since the decree did not specifically provide that she was entitled to live separately and apart from her husband, they were not "legally separated" and the payments were not income to her. The court finds the decree did legally sanction their status of living apart so that the payments properly qualified as periodic alimony or separate maintenance payments. Accordingly, they were includible in the wife's income. *Fugua*, 27 TC No. 112.

Periodic payments to end before ten years after divorce are not taxable alimony [*Nonacquiescence*]. On February 13, taxpayer and her husband entered into a separation agreement which was incorporated in a divorce decree on February 16. The principal sum provided in the agreement was to be paid within ten years from February 13. Since this period was less than ten years from the date of divorce, the payment was not a periodic payment and was not taxable to the wife. [Under the 1954 Code, the ten-year period starts from the date of agreement. *Ed.*] *Newman*, 26 TC No. 88 *nonacq.*, IRB 1957-6.

Wife's overpayment, though from husband's funds, cannot be offset against husband's deficiency [*Acquiescence*]. Taxpayer reported income from an unincorporated business conducted in her Court had held the business belonged to name. In a prior proceeding, the Tax her husband and that he was chargeable with its income. Taxpayer then sought to recover the taxes she had paid out of the business funds. Since husband and wife were separate taxpayers, the Tax Court refused to permit an offset of the wife's overpayment against the husband's deficiency and held that taxpayer was entitled to an order of overpayment. The source of the funds used by the wife in paying her taxes was held to be immaterial. *Stokby*, 26 TC No. 114, *acq.* IRB 1957-6.

Waiver signed by wife only will not affect husband's liability. A husband and wife filed a joint return on March 15, 1951. The wife signed a waiver of the statute of limitations on March 5, 1954, a few days before the statute expired. The court holds the waiver extended the time for assessment of tax against the wife only. However, as liability on a joint return is joint and several, assessment of the full tax can be made against her. *Magaziner, Jr.*, TCM 1957-26.

Dependency credit denied for woman living in household illicitly. Taxpayer lived openly with a married, undivorced woman and claimed her as a dependent as a "member of the taxpayer's household." The court holds Congress never

intended the terms "member" and "household" to be construed so literally as to permit a dependency credit for one maintaining an illicit relationship. *Turnipseed,* 27 TC No. 91.

Father not entitled to claim children living with ex-wife. In accordance with a divorce decree, taxpayer paid $900 per year for the support of his two daughters. The court denies the father dependency exemptions for the children because he failed to prove that his contribution was more than one-half of their total support. *Fenwick,* TCM 1957-36.

Allowance to parent for transporting children to school is not gross income. The IRS rules that mileage allowances to a parent by a school board for transporting children to and from a kindergarten school in his personal automobile are not includible in the parent's gross income. They are merely a refund of a personal expense. Neither can the parent deduct any of the automobile expenses in connection with such transportation. *Rev. Rul.* 57-60.

No deduction for cost of defending criminal action. Legal fees and bond costs paid by taxpayer-attorney in his unsuccessful defense of a criminal action against him for failure to file an income tax return are not deductible. He argued that such expenses were incurred to protect and enhance his professional reputation. *Acker,* TCM 1957-17.

Entertaining expenses disallowed; checks drawn to cash. The president, sole stockholder and chief salesman of the bankrupt taxpayer, drew approximately $450 a week for entertaining. At issue in this bankruptcy proceeding is the validity of the deficiencies arising out of disallowance of this deduction. Admitting that he gambled, producing no books, and being unable to recall the name of a single buyer he had entertained, the president testified that he gave his bookkeeper a weekly listing of his expenditures. The court points out that the income tax return for the corporation was prepared by a CPA and that there was no proof that the expenditures were made. The CPA merely entered the totals appearing on the books on the tax return. *P. M. Undergarment Corp.,* DC N. Y., 1/25/57.

tax problems?

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Well-established dentist can't deduct social club expenses. An elderly, well-established dentist claimed as a business expense $380 paid in the form of dues, meals, and sundry charges to two social clubs. He was unable to give the name of any individual who became his patient in the taxable year as a result of his club memberships. The court disallows the expenses as being primarily personal. *Lokey,* TCM 1957-5.

Raising Persian cats a hobby; loss not deductible. Although taxpayer had been raising Persian cats since 1944, he never realized a profit from the activity. In 1952 he sold 5 kittens for $50. The court refuses to allow a claimed business loss of $106.80 in "breeding, raising, and selling cats"; such activities were nothing more than a hobby. *Conner,* TCM 1956-290.

Ordinary loss allowed on Hungarian nationalization of property. The opinion filed at 27 TC No. 12 (6 JTAX 63) is withdrawn and modified to allow an ordinary loss deduction in connection with veneers that taxpayer owned in Hungary. In 1948, the taxable year involved, the veneers were nationalized. Previously, the court said merely that the loss would be capital because he was not in the veneer business. *Goldner,* 27 TC No. 50.

Storm damage, but not subsequent deterioration, allowed as casualty loss. Damage to taxpayer's residence as a result of a storm in 1951 was determined at $4,000 and allowed as a casualty loss in that year. Deterioration of the residence after the storm could not be taken as a casualty loss in the following year. *Scott,* TCM 1956-274.

Storm loss disallowed; no proof. Since the taxpayer did not introduce any evidence on the amount of his loss, i.e., the difference in value before and after, the court disallows the loss. *Embry,* DC Ky., 8/31/56.

Can deduct board for children institutionalized for medical care. The Service clarifies its position on the deductibility of payment for care of mentally retarded children. When a person is in an institution primarily because of the availability of medical care, the entire cost of care, meals and lodging is deductible. Such payments are also deductible if the primary purpose of attendance at a special school is the alleviation of a mental or physical handicap (as at schools for the blind, deaf or mentally retarded). When medical care is not the principal purpose (home for aged), board and lodging are not deductible. *Spec. Rul.* 9/12/56.

Officers of Coast and Geodetic Survey qualify for retirement credit. Retirement income for individuals under 65 includes income from a public retirement system other than a fund established for the armed forces. Commissioned officers of the Coast and Geodetic Survey are not "members of the armed forces." Their retirement income will therefore qualify for the credit. *Rev. Rul.* 56-651.

Sick pay is "earned income." The Code requires that retirement income be reduced by earned income in excess of $900 or $1200, depending on the age of the individual. The Service holds that sick pay, including the first $100 a week excluded from gross income, is earned income and reduces retirement income. *Rev. Rul.* 57-101.

Consulting engineer can't deduct travel between home in Dallas and office in Washington. Taxpayer claimed airplane and subsistence as incurred while away from home on business. His office was in Washington but his home was in Dallas where his only business interest following the closing of his Dallas office some years previously was scattered real-estate parcels. The Tax Court held that taxpayer failed to prove that Dallas was his "post of duty or principal place of employment." Expenses while traveling from Dallas to Washington and living in Washington were held not deductible. The circuit court affirms. The case turns on disputed facts, and taxpayer failed to sustain the burden of proof. *Marshall,* CA-5, 1/16/57.

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

Commercial art a business; but ICC practice is not

IN MANY jurisdictions, where there are taxes on "business," determining what is a business and what is the practice of a profession inevitably involves great difficulty. We were interested to learn from Sarah Day, a New York attorney, that the New York State Tax Commission ruled recently that commercial artists sh represented were not subject to the New York State unincorporated business tax. The partnership of two brothers used only temporary employees but did a gross of nearly $60,000. They had only a simple studio, and capital was obviously unimportant. Both brothers had had some formal training and long experience in drawing for newspapers. During the year under scrutiny, they worked largely for advertising agencies. One brother developed the layout and illustration from written copy. The other partner, who had been educated as a calligrapher, did the lettering.

The Commissioner recited these facts without discussion and merely announced its conclusion that the unincorporated business tax did not apply.

Another recent New York case held that a nonlawyer licensed to practice as an Interstate Commerce Commission practitioner is subject to the tax (Goodrich, 143 NYS2d 334, aff'd without opinion, Ct. Apls, 11/19/56). This practitioner devoted his full time to representing clients before the ICC and state bodies. The court held that he was not a professional because his work did not require "knowledge of an advanced type in a given field of science or learning gained by a prolonged course of specialized instruction and study." ☆

New decisions this month

New York can tax national advertising solicited through local magazine office. Taxpayer publishes and edits the New Yorker magazine from its principal offices in New York City. In computing gross receipts subject to New York tax, the city taxed all advertising except that solicited through its only out-of-New York office, in Chicago. The magazine argued that New York could tax only the same percentage of advertising as New York circulation was of total circulation. The court rules that because of the local activity of publishing the magazine, the receipts so derived from the sale of advertising were no different for the purpose of local privilege taxation from the solicitation, sale and delivery, in interstate commerce, of a manufacturer's products otherwise arising from exclusively local activity. Jurisdiction to tax the latter, it holds, is firmly established in the law. The court relied in part upon the absence of any danger of multiple taxation in the inclusion of advertising receipts in the tax base since the firm's activities were entirely localized and there was no possibility of another state taxing the income derived from its advertising here held taxable. *New Yorker Magazine,* NY App. Div., 12/9/56.

Out-of-state seller must collect Maryland use tax. Maryland's sales tax law requires vendors engaging in business in the state to collect taxes on sales for use in the state. It includes in its definition of engaging in business "the having of any representative, agent . . . solicitor operating in this State for the purpose of selling, delivering, or the taking of orders or for any tangible personal property." The seller here was an Indiana corporation with no property in Maryland and present in the state only through solicitors who were independent contractors working exclusively on a commission basis. They were not on the corporation's payroll and were not under its supervision. The orders they solicited were mailed to the corporation which had the right to accept or reject them. An attachment was laid on a Maryland retailer who acknowledged owing the Indiana corporation $400. The court holds the Indiana corporation must collect the Maryland use tax. The court bases its ruling on the U. S. Supreme Court decision in General Trading Co. In that case, a Minnesota corporation with no place of business in Iowa, but which sent employee-solicitors into the state, was required to collect the latter state's use tax on its sales. In the instant case the court held that the fact that the solicitors in Maryland were independent contractors while those in the Iowa case were employees of the corporation made no difference so far as the Federal due process clause was concerned, since for all practical purposes both functioned as agents of their respective corporations. *Topps Carment Corp.,* Md. Ct. App., 1/14/57.

Illinois franchise tax on interstate pipeline corporation invalid. Illinois attempted to require a foreign pipeline corporation to pay its franchise and license taxes imposed on "each foreign corporation authorized to do business . . . ." The corporation had been admitted to do both intrastate and interstate business in Illinois, but its sole Illinois business was interstate. It did establish and hold pipelines, pumping stations, and other property in Illinois, and employed personnel to service, repair, and maintain its local property. The law required the tax base — stated capital and paid-in surplus — to be apportioned by the factors of property and business in Illinois to total property and business.

The court held the tax to be imposed upon the *exercise* of the privilege of doing business in Illinois and constitutionally inapplicable to the pipeline corporation since it conducted no intrastate business there, citing Spector and other cases. By way of *dictum,* the court stated that, as applied to the taxpayer here, it was immaterial whether the franchise tax were construed as imposed upon the *granting* of the privilege or its *exercise* since the corporation's interstate business would bear the burden thereof in either event. *Sinclair Pipe Line Co.,* Ill. Sup. Ct., 1/24/57.

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NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

Computing foreign-tax credit made easy; subsidiary v. branch questions simplified

by **ANDREW W. BRAINERD**

The computations which must be made in tax-planning for foreign trade are among the trickiest a tax man must make. One of the most lucid explanations that we've seen of the mechanics and other considerations involved was recently made by the author, a Chicago attorney and foreign taxation expert. Speaking before the Chicago Tax Club, he analyzed these considerations, the multiple uses of foreign corporations, tax traps in the path of their organization, and the simplest method for determining what the foreign tax credit will be.

A United States manufacturer which has engaged in the "export" of goods through its export department has attained a significant volume of profitable business through this channel. At this juncture, the corporation's president receives advice that he should form and use a foreign corporation which would supplant the old export department and thereby take over that profitable export business. He is told that he should form a corporation in some foreign jurisdiction, perhaps Venezuela, that the domestic company then purchase for cash the stock of that corporation, and let it commence, in the U. S., where the parent previously had used an export department.

At this point, the president or his tax advisor must note Section 367 of the Code. That section holds that the exchange of an asset, tangible or intangible, for shares of stock in a foreign corporation, will be held to be a taxable transaction unless, previous to the exchange a favorable ruling from the Treasury has been obtained. Few people would contend that a substantial and profitable segment of a going business does not have any goodwill or intangible value. It is this intangible asset, the goodwill, which has an unrealized value over and above any value in the hands of its original owner. Upon its transfer to a foreign corporation in exchange for its shares, or upon its *contribution* to the foreign corporation under circumstances in which it is "deemed to be in exchange" for the latter's shares, that unrealized value is taxable at capital gain rates unless a previous ruling from the Treasury has been obtained.

For those who might regard this problem under a different light, suppose that the entire domestic company, including all of its activities, export and otherwise, is transferred to a foreign corporation, in exchange for the latter's shares, that those foreign shares are then distributed pro rata to the shareholders of the parent. Such a domestic company might have licensing agreements with foreign parties, as well as various other sources of income having either domestic, or a distinctly foreign source. Were such a transfer possible, the domestic corporation might overnight avoid all U. S. corporate taxation on income from foreign sources. It would seem clear that such a transfer is not without restriction under the reorganization sections of the Code, that the transfer of these entire assets is made, or "deemed to be" made, in exchange for the shares of the foreign company even though no money value be theretofore placed on the intangible or hard-to-value assets. A going-concern value is an asset of provable worth, as has frequently been litigated, and consequently a distinct segment of that business similarly has a value which can be computed.

A great deal has been written about the multiple uses of a foreign corporation. These uses all hinge upon the rule of law that foreign corporations are not taxable in the U. S. on their income derived from sources outside of the U. S. These principal uses include the role of the foreign corporation as a trading company, i.e., as a purchaser of goods, for example, in the U. S. and as a seller of them elsewhere. A foreign corporation may also act as a selling or servicing agency, having active representatives abroad generating income. It can act as a financing company to finance foreign shipments; it can, under proper circumstances, act as a holding company for the shares of foreign sub-subsidiaries, and as a repository for license agreements. And in some instances it can even be used to take advantage of the currency regulations of a country so that an investment in another country, having a monetary agreement with the first country, can be more cheaply made.

One specific situation illustrates a tax advantage to be derived by using a foreign holding company formed in a foreign jurisdiction having beneficial tax treaty relationships with other countries. A French company, doing business in France, is wholly owned by a U. S. parent. Any dividends paid the parent are subject to a withholding tax in France of 18%. Now suppose that instead of forming the French company directly, the U. S. company forms a Swiss (or Dutch, for that matter) holding company, which in turn holds the shares of the French company. Dividends might then be paid out of France to a Swiss holding company, and no French withholding tax would apply because of the favorable tax treaty between those countries. When the Swiss company pays a dividend to the U. S. parent, that dividend would in turn be taxed at 5%, by withholding in Switzerland, but the gross foreign tax would be less. If the U. S.

[1] Art. I of the Venezuela Income Tax Law provides, for example, that, "A tax is hereby created payable by every person . . . upon the net and disposable enrichment obtained by virtue of economic activities realized . . . in Venezuela. An enrichment is understood to arise from economic activities realized in Venezuela when *any* of the causes originating it have occurred within the national territory . . . ."

had no tax treaty with Switzerland, this 5% withholding rate would be increased to the Swiss standard withholding rate of 30% on such payments.

The Wall Street Journal for September 19, 1956, had a brief reference to this "treaty tax advantage" offered by Honduras, the latest foreign country to adopt a tax treaty with the U. S. That heading read: "Banana Republic's Tax-haven Appeal Is Enhanced by Treaty with the United States." The article accurately noted that Honduras was one of the few countries which did not tax foreign (as to it) source income of its corporations, and that this country was one of the very few with a policy of not taxing foreign source income, which had now attained tax treaty status with the U. S. The advantage is a real one in certain situations. It elevates the desirability of using Honduras, as a situs for incorporating these "international" companies, above such countries as Liberia or Venezuela. That latter country, for example, has certain unfortunate provisions within its Code[1] which provide an excellent basis for the taxing of all foreign income of its companies, should its Government wish to tax them. Of course, too, the political tension in Venezuela has understandably discouraged incorporation there, except for a few rather unusual cases where those companies must now live in great uncertainty.

Tax-credit computations

If it is contemplated that foreign earnings be paid into the U. S. parent company with regularity, there is a very good reason for paying *some* foreign taxes, even though it might be possible to do a foreign business which conceivably would pay no foreign taxes whatsoever. The reason is found in those Code sections devoted to the "credit" for payments of foreign income or like taxes paid. The credit applies against the U. S. tax applicable to foreign earnings received here by a domestic corporation, or its 10%-or-more-owned foreign subsidiary, or by any 50%-or-more-owned foreign sub-subsidiary of the first foreign subsidiary. Contrary to what has occasionally been said—that the U. S. company merely "gets credit for foreign taxes paid"—the subject is much more complex than the statement suggests.

TABLE I: ALLOCATION OF FOREIGN TAX TO TAX AND DIVIDEND

		Allocation of tax
Net income before tax	100	25.00
Foreign tax	25	6.25
Net income	75	18.75
Dividend	75	18.75*

*Credit for foreign tax

TABLE II: TAX COST OF SUBSIDIARY AND BRANCH

	Subsidiary	*Allocation of Foreign Tax*	*Branch*
Net income before tax	100.00	25.00	100.00
Foreign tax	25.00	6.25	
Net income	75.00	18.75	
Dividend	75.00	18.75*	
Gross U. S. tax (52%)	39.00		52.00
Less tax credit	18.75		
Net U. S. tax	20.25		
Add foreign tax	25.00		
Total tax on 100 units	45.25		52.00

*Credit for foreign tax

Theoretically, if a foreign tax of between zero and 52% is paid abroad, there will always be a portion of that tax for which we do not, in the U. S., receive credit. If a foreign country has a tax rate of 25%, and a specific company had foreign earnings there before foreign tax of 100 units, there will, accordingly, be left foreign earnings after foreign tax of 75 units. There is a total foreign tax paid of 25 units. Let us assume that the entire amount of after foreign tax, foreign earnings, is paid out as a dividend to the U. S. company. The question is: what is the amount of the tax credit allowable? The answer is simply that a tax credit is allowable here of only that *portion* of the foreign tax which has been paid "on or with respect to" the *dividend* paid to and received by the U. S. parent, or in this instance 18.75 units. You will note that the whole foreign tax paid on *all* foreign earnings is not allowable here, as was formerly held to be the law. A portion of that total foreign tax, namely 6.25 units is that portion of the foreign tax which has been paid previously "on or with respect to" the foreign earnings which were used to pay the entire foreign tax of 25 units.

The concept is a simple one, but quite elusive. Let us approach it from another angle, and trace a situation which leads us to the conclusion that when a foreign tax is paid to a foreign country at an effective rate of anywhere between zero and 52%, there is a definite tax advantage to be gained by using a foreign corporation, rather than operating through a branch of the domestic parent.

At this point, assume that the foreign-tax rate is 25%, and that a full dividend is paid to the parent. The U. S. tax on the distribution amounts only to a tax on the *dividend*, rather than on the net foreign earnings before foreign tax. If the foreign business activity were conducted by a foreign branch of a domestic company, our U. S. tax of 52% would be applicable to the full 100 units. The 25 units of tax paid to the foreign country represent the amount of foreign earnings which are never subject to tax in the U. S., simply because they are never paid in to the U. S. in the form of dividends. They represent that portion of foreign earnings which was devoted to the payment of the entire foreign tax. On those 25 units, not subject to tax here, had a branch earned them, the U. S. tax would have been 13 units, or 52% thereof: from these 13 units, however, let us deduct the amount of foreign taxes which in this instance were actually paid on the 25 units of foreign earnings. We thus deduct 6.25 from 13, and see that the remainder of 6.75 units, which might hereafter be expressed as percentage points, 6.75%, is the amount of the after-tax saving which results from the use, under these circumstances, of a foreign corporation rather than a branch of a U. S. parent. It is apparent from this and the last illustration, that not only is the foreign income taxable in the U. S. reduced from 100 to 75, but the actual U. S. tax

on that income is reduced by the amount of the described credit. It is consequently clear that, as our law is now interpreted, in the computation of our foreign-tax credit we receive not only a *credit* but a *deduction* as well.

For those who care to make a number of calculations, using different foreign tax rates from zero to 52%, it will become apparent that a maximum tax-saving occurs at the midpoint between the two rate extremes, namely at an effective foreign tax rate of 26%. This tax advantage gradually diminishes as the effective foreign-tax rate is either lowered or increased from that point, so that at rates of zero and at 52% and above, the tax cost is the same whether a foreign branch of a domestic company, or a foreign corporation, is used.

Another refinement

There is one other, and little-known, refinement in the calculation of our foreign tax credit. It concerns the interposition of a foreign holding company between a U. S. parent and a wholly owned foreign operating company which does business in one of that dwindling group of foreign countries wherein the effective rate of tax is approximately only 20%. Let us say that the operating company, in the tax year, earns net income before foreign tax, of $125 in the foreign country, that it then pays out a dividend of $100 (all net income after foreign tax) to its foreign holding company intermediate parent, which, either unintentionally or by design, itself pays a foreign tax to the country of its domicile on such dividend income (its sole income) at an effective rate of 25%, for a total of $25 in foreign tax at this level. Under the manner in which our foreign tax credit is computed under present Treasury interpretation, the effective rate of *all* (foreign and domestic) taxes applicable to foreign income earned under these conditions is only scarcely more than 40%. All net foreign income having been brought home in dividends to the United States parent, there is a tax-saving of about 22½% of the tax which would have been paid if the income had been earned in the first instance by a branch of the domestic company. ☆

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New decisions

Guam corporation is foreign. Interest on U. S. Savings Bonds payable to a Guam corporation not engaged in trade or business within the U. S. is subject to withholding, since corporations organized or created under the laws of any U. S. possession are considered foreign corporations for tax purposes. *Rev. Rul.* 56-616.

Nonresident alien employees of U. S. may exclude certain income from U. S. sources. Section 861(a)(3) of the 1954 Code excludes from gross income compensation for services even though rendered within the U. S. if (a) the services are performed by a nonresident alien in the U. S. less than 90 days, (b) if the compensation does not exceed $3,000, and (c) if the services are performed for either a foreign employer or for a foreign branch of a domestic corporation. The Service rules that the U. S. Government is a corporation. Employees of U. S. agencies or instrumentalities in foreign countries, other than U. S. citizens or resident aliens, may be exempt from tax on their compensation for services performed in the U. S. if they otherwise qualify under Section 861(a)(3). *Rev. Rul.* 57-69.

80% partner's activities here put foreign partnership in business. [*Certiorari denied*]. Taxpayer came to this country to represent his foreign partnership in buying autos and equipment. Technically, title passed in the U. S. from the partnership to the ultimate user — the Argentine Government. The district court held that sales were not made in the U. S. and that the partnership was therefore not taxable on the profit. The Eighth Circuit reversed. The partner was far more than a mere purchasing agent, and the partnership was engaged in business here. The circuit court said it need not determine whether mere technical passage of title here would make the profit "from U. S. sources." The substance of the sales occurred in the U. S. *Balanowski, cert. denied,* CA-2 8/14/56.

Philippine "privilege" tax is not allowable as credit. The Philippine privilege tax required to be paid before the commencement of specified business and occupations is not an income tax and is therefore not allowable as a foreign-tax credit against the U. S. income tax. *Rev. Rul.* 57-62.

Insurance commissions earned in Japan nontaxable; taxpayer was bona fide foreign resident. Taxpayer went to Japan in 1949 with his wife for an extended stay to sell life insurance to U. S. servicemen stationed there. He and his wife returned to the U. S. in May 1950 for a vacation and to confer with his employer, and did not return to Japan until December 1950. After consideration of all the facts, the court holds taxpayer was a bona fide resident of Japan for the entire year 1950. Accordingly the insurance commissions earned for writing policies in Japan were properly excluded from his gross income. [For 1951 and later years, mere physical presence abroad will qualify earning for exemption. *Ed.*] *Walker,* TCM 1957-40.

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NEW DEVELOPMENTS IN

Taxation of oil & gas

EDITED BY GODFREY WM. WELSCH, LL.B., CPA

New decisions and proposed legislation muddle status of carved-out oil payments

by WILLIAM McCLURE

In five recent cases, the Fifth Circuit, ruled that transfers of carved-out oil payments were taxable at capital gains rates. On the other hand, the Seventh Circuit ruled that ordinary rates applied. A bill introduced in Congress by Representative Mills in 1956 would provide for ordinary income taxation, but professional groups have objected to it on technical grounds and submitted alternative drafts. All these recent developments, and the latest news on A-B-C transactions are here reviewed by the author, a Washington D. C., attorney, in the first of a series of articles based on his remarks before the Eighth Institute on Oil and Gas Taxation sponsored by the Southwestern Legal Foundation.

DURING THE past year, the courts decided several important cases dealing with carved-out production payments. In *Hawn*,[1] the Fifth Circuit, reversing a Tax Court decision, held that the transfer of a carved-out production payment resulted in the mere assignment of future income and not the sale of a capital asset. The *Hawn* case presented an unusual set of facts which, unfortunately for the taxpayer, gave the appearance of a plan designed solely for the tax-saving purpose of temporarily transferring the taxpayer's right to certain income.

In 1949, Hawn entered into a contract with a building contractor. The builder was to construct a house for the taxpayer for $115,000. In order to help the contractor finance the cost of construction, Hawn, on October 1, 1949, assigned to him an oil payment which the taxpayer owned until the amount of $120,000 had been received therefrom by the contractor.

Rejecting the taxpayer's contention that the sale of an oil payment is a sale of property under Section 117 of the 1939 Code requiring capital gains treatment, the court was very much impressed by the fact that the oil payment, exhausted in 19 months, was a very small part of the property out of which it was carved. The court concluded that the transfer was of such an insubstantial part of the whole property that no sale actually occurred but rather a mere assignment of anticipated income resulted. The court stated:[2]

"The previous court decisions by which our actions are circumscribed clearly teach that if, in truth, a transfer of a part of future income merely puts in the transferee a right to collect such a part of the total future income as is insubstantial either in relation to the total amount receivable or to the time during which it will be received, such transfer does not make it the income of the transferee for tax purposes."[3]

The court specifically stated that it had committed itself in *Caldwell v. Campbell*[4] to the proposition that a transfer for value of an oil payment lasting for periods ranging from 9 to 13 years, under the particular facts involved in that case, constituted a sale of a capital asset.

After the *Hawn* decision, most tax practitioners thought that the Fifth Circuit had at least announced a standard, even if its proper application remained somewhat unsettled. On the basis of this decision, they reasoned that if an oil payment constituted a substantial amount of the property out of which it was carved, the court would likely hold that it did not constitute an assignment of income. On the other hand, it was expected that if the transfer did not involve a large proportion either in quantity or value of the property out of which it was carved, the court could be expected to treat the transfer merely as an assignment of future income.

However, there soon came before the Fifth Circuit five important cases involving the tax treatment of transfer of production payments. These cases (four from the Tax Court and one from a district court) had all been decided against the Government at the trial level, and presented a wide assortment of sizes of the production payments compared with the properties from which they were carved. It was expected that, in deciding these cases, the Fifth Circuit would further indicate how much property must be carved from the parent property to warrant capital gain treatment. But the court did not undertake to draw a line between substantial and insubstantial transfers; it explained its decision in *Hawn* as a special situation and made it unmistakably clear that it did not intend to establish any such quantitative standard as "substantiality."

The first of these cases was *Scofield v. O'Connor*.[5] It involved the sale of a $10,000,000 oil payment carved from the entire interest of several royalties owned by an estate. The actual payout period was approximately three years, and the amount of the oil payment constituted about 17% of the total estimated recoverable oil in place attributable to the royalty interests held by the taxpayer-estate. The taxpayer claimed that, based on dollar value at the time of transfer, the oil payment constituted approximately 45% of the taxpayer's royalty interests.

In the second case, *Commissioner v. Weed*,[6] a sulphur payment was carved out of a portion of the taxpayer's royalty interest. Although the sulphur payment was expected to pay out in four years, it actually paid out in 28 months. The sulphur payment constituted only ap-

[1] Commissioner v. Hawn, 231 F2d 340 (5th Cir. 1956).
[2] The court went on further to say that the effect was the same as though the taxpayer had borrowed the funds required using the oil payment as collateral and applied the proceeds of such loan to pay the contractor and then repaid his loan as the income from the oil payment was received.
[3] Although the decision of the Court is not clear on the point, it is understood that Hawn was taxed on the income as obtained from the production payment, rather than upon the proceeds of the sale of the oil payment.
[4] Caldwell v. Campbell, 218 F2d 567 (5th Cir.).
[5] O'Connor v. Scofield, F2d (5th Cir. 1957), 6 JTAX 204.

proximately 11% of the taxpayer's entire royalty interest.

The third case was *Commissioner v. P. G. Lake Inc.*[7] A leasehold owner transferred an oil payment out of part of its leasehold interest to liquidate a debt which it owed its president. The oil payment had an expected and an actual payout period of about three years.

In *Commissioner v. Wrather*,[8] the taxpayers were also leasehold owners. They transferred oil payments out of 9/10 of two of their leasehold interests. The oil payments were expected to pay out in from four to six years, but actually paid out in less time.

Finally, *Fleming v. Commissioner*[9] involved both transfers of oil payments carved out of leasehold interests and the transfer of an oil payment carved out of a royalty interest. The actual payout periods of the various oil payments ranged from three years to nine years and ten months.

The Fifth Circuit affirmed the decisions of the lower courts in these five cases. In each, it held that there was a sale of a capital asset. In the cases involving the transfers of production payments from royalties or other oil payments, it held that there were bona fide sales involved requiring the application of the capital gain provisions. In the *O'Connor* case, it stated that if it drew a time limit to determine whether the sale of a production payment was substantial enough to constitute a sale entitling the taxpayer to capital gain treatment, it would be rendering judicial legislation. It then concluded that all of the facts should be taken into consideration in determining whether as a matter of law a transaction was or was not a bona fide sale of capital assets so as to entitle the taxpayer to capital gains treatment under Section 117.

It was pointed out that in the *Hawn* case there was no sale at all but rather merely a credit arrangement. Although this was in the form of an assignment of an oil interest, it was in fact nothing but an anticipatory assignment of income made as security for, and in payment of, Hawn's debt to the contractor.

In the cases involving the transfer of production payments carved from leasehold interests, the court disdainfully rejected all the Government's contentions. First, as pointed out in the *Lake* decision, it saw no difference in result between a transfer of a production payment from a leasehold interest on the one hand and a transfer of a production payment from a royalty or oil payment on the other hand. Here the court stated:

"An examination of the many cases, Federal and state, which have dealt with oil payments, shows that, without varying, the courts have treated alike oil payments whether carved out of the working or the royalty interests, and that the so-called distinction between them, which the Commissioner urges here, has never been made before."

The court also denounced the Service's alternative argument that even if a production payment be considered property for purposes of Section 117, it was nevertheless property which the taxpayer held primarily for sale to customers in the course of its oil business and was therefore expressly excluded from the Section 117(a) definition of capital asset, since what the taxpayers were selling was nothing more than the oil itself. It treated this argument as a contention by the Government that the taxpayer was selling personalty and rejected it on the basis that the assignee received a part of what the assignor owned—realty.

It also summarily rejected another alternative argument of the Commissioner that the property could not have been held for the required six-month period since it was created by the transfer. On this point, it said:

"Of the Commissioner's third contention, that the sale was not of property held for more than six months, it is sufficient to say that the parties have stipulated, and the facts show, that the properties out of which the interest was carved had been held for more than that time and that the Commissioner's contention, that the property sold came into existence with, and only with, its assignment, is contrary to legal principles indeed, is little short of legal legerdemain."

Finally, the court quashed the Service's contention that the assignee was not entitled to depletion on the proceeds received from the production attributable to the production payment. It stated briefly that where the instrument involved transferred to the assignee an economic interest, the assignee is entitled to depletion on the proceeds received from production.[10]

Conflict with Slagter

Thus, it appears that in the Fifth Circuit the taxpayer will be deprived of capital gain treatment only where the facts are such that it is obvious there was really no sale at all. This rule appears to conflict with the decision of the Seventh Circuit in *Commissioner v. Slagter*.[11]

In that case, an oil payment was assigned out of 60% of the taxpayer's interest in several oil and gas leases. The payout period was estimated to be seven years and ten months: however, the actual payout period was only five years and three and one-half months.

The Seventh Circuit, reversing the Tax Court, applied the familiar assignment-of-income doctrine established by the Supreme Court in *Helvering v. Horst*. According to this and other cases, the power to dispose of income is the equivalent of ownership of it, and the exercise of that power to procure the payment of income to another is the enjoyment thereof. In the Seventh Circuit's view, the taxpayer-transferors owned and controlled the right to produce oil and gas on the leases and the right to receive the money realized from the operation of the well. Therefore, when the taxpayers secured an advancement of this money, they remained liable to pay taxes upon the income when obtained from the property.[12] Thus, it appears that the Seventh Circuit is not concerned with the bona fides of the sale and therefore would probably have decided contrary to the Fifth Circuit in the *O'Connor*, *Lake*, *Weed*, *Wrather* and *Fleming* cases.[13]

Certainly, the conclusion of the Seventh Circuit appears to conflict with the rule now laid down by the Fifth Circuit that whether there is a bona fide sale, a transfer of a capital asset results within the contemplation of Section 117. That the Government will

[6] Weed v. Commissioner, F2d (5th Cir. 1957), 6 JTAX 204.
[7] P. G. Lake, Inc. v. Commissioner, F2d (5th Cir. 1957), 6 JTAX 204.
[8] Wrather v. Commissioner, F2d (5th Cir. 1957), 6 JTAX 204.
[9] Fleming v. Commissioner, F2d (5th Cir. 1957), 6 JTAX 214.
[10] Actually the court was not required to render an opinion as to whether capital gains or ordinary income resulted in the *Fleming* case, for there the court held that the transfer of production payments carved out by the taxpayer for a ranch and urban business properties constituted exchanges of properties of like kind within the purview of Section 112(b)(1) of the 1939 Code. The court's holding that the exchange of properties was nontaxable avoided the necessity for reaching the capital gain versus ordinary income issue.
[11] Commissioner v. Slagter, F2d (7th Cir. 1956), 6 JTAX 136.
[12] The court did not mention the test of substantiality laid down by the Fifth Circuit in the *Hawn* case.
[13] Of additional interest in the *Slagter* case, is the fact that the court specifically held that the income was taxable to the taxpayer when realized from the sale of production attributable to the oil payment. This holding, of course, is contrary to the Government's position that the transferor is taxable on the amount received from the transferee.
[14] See 1956 P-H Fed. ¶76,732.

petition for writs of certiorari in the five Fifth Circuit cases appears inevitable.

Proposal for legislative change

There is also a strong prospect for legislative action concerning the treatment of such production payments. During the 1956 session of Congress, Representative Mills introduced HR 9559, which would, among other things, provide ordinary income treatment to the assignor of a carved-out production payment. This bill has been criticized in many technical respects. Both the Southwestern Legal Foundation and the American Bar Association have presented to the Administration and Congress drafts of proposed bills (almost identical in phraseology) which would accomplish the stated purposes of HR 9559 and overcome the technical objections. These drafts would provide generally that the sale or exchange of a production payment carved out by the taxpayer results in ordinary income, subject to depletion, to the transferor. This rule, however, is made expressly inapplicable where the proceeds are pledged for the exploration, drilling, development, or equipping the property from or out of which the carved-out production payment is created. Further, the rule would not apply where such carved-out production payment is exchanged for services, materials, and the like used in the acquisition, exploration, drilling, development, equipping, or operation of the property from which the carved-out production payment is created.

Generally speaking, under these drafts, as the donee of a gift receives the proceeds from the sale of production attributable to the production payment he will be treated as receiving a gift from the donor, and the donor will be treated as having received income subject to the allowance for depletion. If the donee sells or exchanges the production payment, then the consideration received by him will be treated as income to the donor. Assuming a bona fide sale or exchange by the donee under such circumstances, the donor will have no further income attributable to him in respect of such production payment.

According to the drafts, a corporation distributing such a production payment as a dividend to its shareholders would realize income to the extent of the fair market value of the production payment on the date of distribution subject to the allowance for depletion. The drafts would amend Section 1031(a) of the 1954 Code so as to add carved-out production payments to the list of properties which may not be accorded tax-free exchange treatment. They would also amend Section 351(a) to make clear that exchanges of carved-out production payments will not be given the tax-free exchange treatment generally accorded transfers to controlled corporations.

It is hoped that the Treasury Department and the Joint Committee on Internal Revenue Taxation will recommend to Congress during 1957 a bill which will be quite similar to the drafts presented by the Southwestern Legal Foundation and the American Bar Association. However, whether or not such recommendation will be for a bill similar to and in the detailed form of these drafts, it appears quite likely that there will be legislation in this area during this session of Congress. Legislation dealing with the taxation of carved-out production payments headed the list of a group of unintended benefits and unintended hardships prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Treasury Department which was presented to the Subcommittee on Internal Revenue Taxation on November 7, 1956. [See 5 JTAX 322.]

Retained production payments

The same list of unintended benefits and hardships contained the following statement:

"It is suggested that the subcommittee may also want to examine various other arrangements by which interests in oil and other mineral production are sold, such as cases where the production payments are sold after the taxpayer has previously disposed of operating interests in mineral production."

Although this statement cast doubt on the status of the A-B-C transaction, it is understood that it was later decided not to disturb the A-B-C transaction, at least during 1957. Probably the main reason for such a decision was that a change of the law in that area would require a complete study and perhaps extensive revision of the capital gain provisions of the Code, and the Subcommittee is not prepared for such an undertaking.

Perhaps the Ruling given the Atlantic Refining Company on May 15, 1956, dealing with an A-B-C- transaction, had as much to do with bringing that type of transaction to Congress' attention as anything else.[14] The facts as stated in that Ruling show that Atlantic purchased oil and gas properties of Houston Oil Company for approximately $75,000,000. However, Houston retained two oil payments, payable out of 85% of the working interest gross income. These oil payments amounted to $58,000,000 and $67,000,000 (plus interest on the unpaid balances), and were expected to pay out in approximately ten years.

The Service ruled that the proceeds of production attributable to Houston's retained production payments would not be includible in the gross income of Atlantic. Further, it stated that operating costs incurred by Atlantic would be deductible in computing Atlantic's taxable income, if at the date of the purchase it was expected that the portion of the income from production accruing to Atlantic during the payout period, would be sufficient to pay operating costs. However, if at the time of the purchase it was contemplated that over the payout period a loss from the operation (not due to development) may be anticipated, the excess of operating costs over income received must be capitalized each year as additional cost of the properties.

The Service ruled that since Atlantic would be the sole owner of the working interest subject to the production payments it will be entitled to the election with respect to intangibles permitted by Section 263(c) of the 1954 Code. Finally, it was determined that costs which are not otherwise deductible as intangible drilling and development costs incurred by Atlantic, as an operator of the oil and gas wells, in connection with drilling nonproductive wells, would be deductible as ordinary losses.

The Francis case

Before the issuance of this Ruling, a

tax problems?

For the quick answer to *all* Federal tax questions, keep Alexander's Federal Tax Handbook, 1957 Edition, on your desk at all times. See back cover for order blank.

refund action had been filed in a district court. Closely watched by tax practitioners, this case, *Francis Oil and Gas Co. v. United States,* involved a taxpayer who had purchased a one-half interest in certain leases for $540,000, payable $165,000 in cash and $375,000 out of 95% of the production from the interest acquired. The Francis Oil Company incurred operating expenses in excess of the 5% of the production received by it, and in addition it incurred intangible drilling and development costs. Originally the Service denied these deductions to the extent that they exceeded Francis' share of the gross income, requiring that the excess should be capitalized as an additional cost of the leases acquired. The Government, however, in its pleadings conceded that the taxpayer was entitled to the deduction for the intangible drilling and development costs to the extent of its ownership in the working interest without regard to the amount of gross income received. But it still contended that under no circumstances was the taxpayer entitled to deduct the operating expenses in excess of the operator's share of the gross income. The Ruling issued to the Atlantic Refining Company apparently signaled an abandonment of the unconditional position taken by the Government in the *Francis Oil Company* case, for shortly thereafter the case was settled. ☆

Miscellaneous new decisions this month

Title insurance reserves under 1945 New York law deductible [*Acquiescence*]. An insurance company computes its taxable premium income in part by adding unearned premiums at the beginning of the period to premiums on contracts during the period, and deducting the unearned at the year end. Generally, premiums set aside by state law are deductible if the company is unable to use them; mere solvency reserves are not deductible. Upon change of the New York insurance law in 1945, certain reserves were required. The Commissioner held (*Rev. Rul.* 151, 1953-2 CB 22) that no deduction could be made for reserves set up out of premiums received prior to 1945. This Ruling is now revoked. The reserves are deductible no matter when the premiums were collected. *Rev. Rul.* 57-48. The Commissioner withdraws his nonacquiescence in a case so holding. *Home Title Guaranty Co.,* 15 TC 637, *acq.* IRB 1957-6.

Depletion election is also decision to treat operating interests separately. The 1954 Code permits the owner of natural deposits to elect to treat as one property (for percentage depletion, cost depletion and gain or loss on sale) separate interests which form one operating unit. The Service holds that such an election, provided for in Section 614(b), is an election not only to aggregate separate interests as one property, but also to treat as separate properties each operating unit. *Rev. Rul.* 56-614.

Insurance company's home-office expense not "investment" cost. A mutual life-insurance company which is taxable on investment income was held not entitled to deduct as investment expenses those portions of real-estate expenses, taxes, and depreciation on its home-office property which it allocated to its investment operations. *State Mutual Life Ass'n Co. of Worcester,* 27 TC No. 60.

Section 331 distribution not deductible by bank as a "dividend" on deposits. Domestic building and loan associations in liquidation may deduct from gross income amounts paid or credited as dividends on withdrawable shares. The IRS holds that undistributed earnings distributed in a Sec. 331 liquidation to the holders of withdrawable shares are not deductible as "dividends" paid. However, amounts paid or credited to shareholders prior to formal action to liquidate may be deducted if such amounts are withdrawable on demand subject only to the customary notice. *Rev. Rul.* 57-39.

Ordinary treatment processes for clay depletion includes burning and loading brick. Percentage depletion is computed on gross income from mining, including ordinary treatment processes, to obtain the commercially marketable mineral product. The court found that only a minute amount of clay is sold prior to baking into brick; therefore gross income must be computed at that point. The Tenth Circuit affirms. *Sapulpa Brick & Tile Corp.,* CA-10, 12/20/56.

Pocket adding machines not taxable business machine. Taxpayer manufactures an adding device that will add up to 9999. While it is an "adding machine," it is not a business and store machine, and is therefore not subject to excise tax. However, to collect a refund of tax paid, the taxpayer must show he absorbed the tax. The only evidence that he did was the taxpayer's testimony, which the courts holds is inadequate proof. The taxpayer should have produced records to show how cost was determined. *Vogel,* DC Minn., 1/3/

No stamp tax on transfer; surplus transferred to capital. Taxpayer-corporation increased its capital account by transferring $12 million from the capital surplus and earned-surplus accounts. The court holds that no stamp tax is due. There was no increase in the number of shares; the transfer resulted merely in an increase in the stated value of the already issued and outstanding no-par common shares. This is not the equivalent of issuing new stock. *American Steel Foundries,* CA-7, 11/27/56.

Only newly dedicated capital subject to documentary tax in stock split. Taxpayer-corporation distributed one additional share for every two shares outstanding, transferring $1 per share from its earned surplus account to its stock account. The market price per share after this distribution was $57. The court holds that the documentary tax in a recapitalization is computed on amounts newly dedicated to capital. In this case $1 (transferred from earned surplus) of the of the $57 value is new capital. *Lily Tulip Cup Corp., DC Ga.,* 3/4/57.

Capital gain on disposal of timber with retained interest. In *Ah Pah Redwood* (26 TC 1197), the Tax Court held that a lumber company which engaged in no logging activities realized ordinary income on the sale of timber to others who did the logging. The court said the timber was held for sale to customers in the ordinary course of business. The Service now rules that the disposal of timber held for more than six months by the owner who retains an economic interest therein qualifies for capital gain regardless of the nature of the owner's business or the purpose for which the timber is held. To the extent *Ah Pah Redwood* is inconsistent, it does not represent the position of the Service. *Rev. Rul.* 57-90.

Excess Profits

Is the Commissioner unfairly requiring a double reduction for interest in EPT?

PRESUMABLY, ONLY those of you who have still-open EPT years are going to get really hot under the collar about Rev. Rul. 54-534. In it, the Commissioner took the position that the 75% of the interest expense must be disallowed in an EPT year if the taxpayer computed his base-period income by an industry rate on total assets. The type of relief was given to new corporations and those which made changes during the base period.

On this point, Jacquin Bierman sent us a very interesting note. He points out the fact that the industry rate of interest is not only used to reduce the excess profits credit but also to increase the taxable year's income.

To explain his position, Mr. Bierman (who is with J. K. Lasser & Co., New York) offers computations involving six different situations: (1) no relief claimed and a straight-average base-period income is used; (2) the borrowing occurred during an EPT year; (3) an industry rate of return on total assets is used and the borrowed funds are reflected in the computation of total assets, as Mr. Bierman thinks they should be; (4) the computation is made according to the Ruling, when the borrowed funds are included in the total assets; (5) the computation is made as Mr. Bierman would do it when the borrowing is made during an EPT year; (6) the computation is made as the Commissioner would do it when the borrowing is made during an EPT year.

Assume an increase in assets of $100, represented by a note payable, carrying an interest rate of five per cent. If this amount had been borrowed at the beginning of the base period, the earnings attributed to it throughout the base period would have been reflected in the actual average base period net income. Interest paid would have been deducted.

Assume that the company earned 12 per cent on its assets, and that the loans were still outstanding during the excess profits tax years. The excess profits tax effect would be as in the following computation.	
Earnings based on borrowings ($100 × 12%)	$12.00
Less interest ($100 × 5%)	5.00
Average base period net income comprising the excess profits credit	$ 7.00
Interest deduction during excess profits tax year ($100 × 5%)	5.00
Total benefit to taxpayer (credit plus current interest deduction) in computing excess profits	$12.00

Now suppose that the $100 was borrowed on January 1, 1951. The effect upon the tax would be shown through the capital addition, and would be as follows:

Borrowed Capital Addition ($100× 75%)	$75.00	
Increase in credit for net capital addition ($75 × 12%)		$ 9.00
Interest deduction during excess profits tax year ($100 × 5%)	$ 5.00	
Less reduction in interest deduction by Sec. 433(a)(1)(O) ($5.00 × 75/100 or 75%)	3.75	
Excess profits tax year interest deduction		1.25
Total benefit to taxpayer (credit plus current interest deduction) in computing excess profits tax		$10.25

Relief, loan in total assets per JB

Now suppose that relief under Section 443 or under Section 445 for the fourth year (or later) is being computed. Assume that the $100 of borrowing is included in "total assets," and that the industry rate of return is 12 per cent. The following results:

"Total assets" due to borrowed capital	$100	
Relief computation of average base-period net income ($100 × 12%)		5.00
Section 443 or 445 average base-period net income included in the excess profits credit		7.00
Interest deduction during excess profits tax year ($100 × 5%)		5.00
Total benefit to taxpayer (credit plus current interest deduction) in computing excess profits tax		$12.00

But Rev. Rul. 54-534 causes this further distortion. Let us start with:

Relief credit of		$7.00
Interest deduction during excess profits tax year ($100 × 5%)	$5.00	
Rev. Rul. 54-534 reduction because of Sec. 433(a)(1)(O) ($5.00 × 75/100 or 75%)	3.75	
Rev. Rul. 54-534 interest deduction		1.25
Total reductions pursuant to Rev. Rul. 54-534		$9.25

This amount is lower than would have been obtained, either through the regular average base-period net income or through capital additions, if relief was not required.

Relief, loan during EPT year per JB

Now suppose that relief under Section 445 for the first three years is being determined. Assume that the $100 was borrowed after the end of the last non-excess profits tax year, and that the 12 per cent industry rate obtains. The $100 will enter into "total assets" as a capital addition under Section 445, at 75%. The following obtains:

"Total assets" due to borrowed capital ($100 × 75%)	$75	
Relief computation of average base-period net income ($75 × 12%)		$9.00
Less interest on borrowing $100 × 5%)		5.00
Section 445 average base-period net income included in the excess profits credit		$4.00
Interest deduction during excess profits tax year ($100 × 5%)		5.00
Total benefit to taxpayer (credit plus current interest reduction) in computing excess profits tax		$9.00

Relief, loan during EPT year per IRS

This amount, apparently required by statute, is less than any prior calculation. Nevertheless, Rev. Rul. 54-534 would reduce it still further by the second interest adjustment under Section 433(a)(1)(O):

Start with the relief credit of		$4.00
Interest deduction during excess profits tax year ($100 × 5%)	$5.00	
Rev. Rul. 54-534 reduction because of Sec. 433(a)(1)(O) ($5.00 × 75/100 or 75%)	3.75	
Rev. Rul. 54-534 interest deduction		1.25
Total benefits to taxpayer pursuant to Rev. Rul. 54-534		$5.25

It must be obvious that the results of Rev. Rul. 54-534 are neither sound nor within the statutory intendment.

The formula for the reduction of interest under Section 433(a)(1)(O) is: *Take 75% of the* increase in borrowed capital during the excess profits tax years; *divide the result by the* average borrowed capital for the excess profits tax year; *and multiply that figure by the* interest on indebtedness included in daily borrowed capital.

Transposing Section 443 or Section 445 into the Section 433(a)(1)(O) formula produces this result: [(75% × Zero), Zero] *divided* by average borrowed capital for the excess profits tax year, *multiplied by* interest on indebtedness included in daily borrowed capital.

EXCESS PROFITS TAXATION: RECENT DECISIONS

EPT permits exclusion of income from unamortized premium despite loss on redemption. Upon retirement of its bonds in 1945, taxpayer had some $90,000 of unamortized premium on issuance which, while includible in income for income tax, was specifically excluded by the Code from excess profits tax. The district court holds that this is proper even though the bonds were redeemed at some $270,000 over par, a deductible loss for both income and excess profits tax. *Public Service Co. of Oklahoma,* CA-10, 1/21/57.

Taxpayer may qualify for EPT relief for both abnormalities and excess output. Relief was provided from excess profits tax for excess output of certain minerals (Section 453) and for abnormalities in excess profits tax years (Section 456). Taxpayers may qualify under both sections. Further, the principles of *Rev. Rul.* 235, 1953-2 CB 235, relating to the determination of abnormal income for excess profits tax purposes in the oil and gas extraction industry, is equally applicable to corporations engaged in other mineral enterprises. *Rev. Rul.* 57-100.

EPT 722 relief. Relief under 722 is denied a used-bag manufacturer which had expanded its operations during its first base-period year. It failed to present an acceptable constructive average base-period net income. *Central Bag Co.,* 27 TC No. 24. Relief is also denied a Nebraska candy manufacturer. The court finds it had overestimated the effect of a drought on its base-period sales. *Gillen and Boney,* 27 TC No. 25. But a California fruit juice canner is permitted to use a constructive average base period net income. Its business was depressed by an abnormal freeze in 1937. *Tree Sweet Products Co.,* 27 TC No. 26.

A hydraulic press manufacturer is granted relief because of changes in its products, an increase in its capacity for production or operation for which it was committed prior to January 1, 1940, and a change in the ratio of nonborrowed capital to total capital. *Hydraulic Press Mfg. Co.,* 27 TC No. 29.

EPT income under 722 is amount excluded from income tax. A constructive-average base-period net income under Section 722 was allowed to taxpayer. The court affirming the decision of the Tax Court, holds that the excess profits income determined by using the constructive credit is the amount of income excluded from income tax under Section 26(e) of the 1939 Code. *Mutual Shoe Co.,* CA-1, 11/9/56.

721 relief denied; no basis for apportioning net abnormal income to prior years. In 1935 taxpayer commenced planning and other preparatory work for the publication of a technical magazine. Due to the activities of a competitor, taxpayer was not able to bring out the new magazine until 1942 when it scored an immediate financial success. Taxpayer sought a reduction in its 1943 excess profits tax under the "abnormal income" relief provisions of Section 721. Relief is denied. Even if taxpayer could satisfy all the other requirements of Section 721, it failed to establish the total amount expended in research or development activities in any of the prior years, thereby making it impossible to attribute any of the net abnormal income in 1943 to such prior years. *Caldwell-Clements, Inc.* 27 TC No. 78.

"Capital note" to RFC is EPT equity capital. In 1934, taxpayer-bank sold $200,000 of "capital notes" to the RFC. Taxpayer's contention that this was invested, not borrowed capital, is upheld by the court. Under Missouri banking statutes, it was impossible for taxpayer to issue preferred stock, and Congress had authorized the RFC to buy capital notes in such instances. Comparison of the preferred stock and the capital notes showed them to be substantially alike. *Mercantile Bank,* Ct. Cls., 1/16/57.

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NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Three states announce increased benefits

Wyoming benefits increased to 4%. For benefit years beginning on and after July 1, 1957, and on and after any July 1 thereafter, Wyoming will pay a weekly benefit amount of 4% of the workers highest base period quarter's wages. Such weekly benefit amount will not be less than $10 nor will it be more than 55% of the average total weekly wages of all insured workers in the calendar year preceding such July 1. The weekly benefits currently range from $10 to $30.

The duration of benefits now ranges from 8 weeks to 26 weeks based on base period wages. Effective July 1 the duration will be the lesser of 26 times the weekly benefit amount or 30% of the claimant's base period wages.

Wyoming workers who voluntarily quit, refused suitable employment, or were discharged for misconduct could not draw benefits until they had one week of subsequent employment. Now such workers are disqualified from receiving benefits for a flat three weeks.

Also, a claimant's unemployment benefits will no longer be reduced by the receipt of workmen's compensation, Federal old-age, or temporary partial disability benefits.

For the year 1958 and thereafter, Wyoming employers may make a voluntary contribution in order to secure a reduced rate.

Several changes in Montana unemployment benefits. Maximum weekly unemployment benefits in Montana were raised effective April 1 from $26 to $32. The duration of benefits was increased from 20 weeks to 22 weeks. Also, the one week waiting period has been eliminated..

Effective March 8 the maximum disqualification period was reduced from nine weeks to four weeks for voluntary leaving and refusal of suitable work, and from five weeks to four weeks for misconduct.

For the calendar year 1957 and thereafter employers in Montana may make voluntary contributions to secure a lower rate. ☆

South Dakota unemployment benefits up 16%. Effective July 1, 1957 South Dakota unemployment insurance claimants may draw maximum weekly benefits of $28. The current maximum is $25.

The maximum benefits payable thus have been increased from $500 to $560.

Unemployment benefits up, taxes down

THE UNEMPLOYMENT BENEFIT ADVISORS, INC. recently released certain fiscal data pertaining to State Unemployment Compensation Systems for the calendar years 1951 through 1955 inclusive. We are reproducing in the accompanying box some of the summary data which we feel many of our readers will find interesting.

Particular attention is called to the dollar amounts of reserves and reserve percentages at December 31, 1954 and 1955. Note that while the reserves increased dollar-wise at the year-end in 1955 over 1954, the reserve percentages decreased from 8.5% to 8.1%. This decrease in reserve percentages was due to over-all increases in taxable payroll.

Also of interest is the average employer's contribution rate of 1.2% for the calendar year 1955. This average contribution rate represents a saving of more than $1.5 billion to employers who are operating in experience rating states, and whose rates have been reduced from the standard 2.7% rate. ☆

Why labor opposes combined reporting

WHENEVER efforts are made to get the Federal Government to permit "combined reporting" of OASI and income-tax withholding, mention is made that "labor opposes combined reporting" [see, e.g., 6 JTAX 189]. The great and obvious savings in money and effort which result from combined reporting make it important to understand this apparent opposition of labor.

The objection is twofold. First of all labor feels that once the quarterly Federal returns are eliminated there will be pressure brought to bear in the various states to eliminate state returns on a quarterly basis. This would lead to the system known as "request reporting" which is presently in effect in some states, among them being New York and Massachusetts. "Request reporting" has a tendency to make employers more aware of unemployment insurance costs since the state must contact the employer and secure payroll and personnel information each time a claim is filed. The labor groups generally do not like this approach. In addition, they feel that "request reporting" results in slowups in payments, but this has not actually been proved in practice.

Second, the labor groups also fear that, if states eliminate quarterly reports, there may be some tendency to switch their unemployment insurance computations to an annual wage base. This would tend to lower the benefit computation in those states where it is now predicated upon wages paid in the highest quarter. ☆

UNEMPLOYMENT COLLECTIONS, PAYMENTS AND RESERVES

	1951	*1952*	*1953*	*1954*	*1955*
Amount of Taxes Collected (000) ...	$1,492,509	$1,367,676	$1,347,630	$1,136,154	$1,208,785
Benefit Payments (000) ...	840,411	998,237	962,221	2,026,866	1,350,268
Ratio of Benefits to Taxable Payroll ..	0.9%	1.1%	1.0%	2.1%	1.3%
Reserves As of Dec. 31 fo Each Year (000) .	$7,782,048	$8,327,560	$8,912,821	$8,219,084	$8,263,850
Ratio of Reserves To Taxable Payrolls ..	8.6%	8.8%	8.9%	8.5%	8.1%
Average Employer Contribution Rate.	1.6%	1.4%	1.3%	1.1%	1.2%

MANAGEMENT OF THE
Professional tax practice
AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

Kentucky Bar holds any work on tax return is "practice of law"; seeks court order

"THE MINUTE a single act is done to a tax return the party so doing is practicing law," says Unauthorized Practice of Law Committee of the Kentucky State Bar Association. In an advisory opinion, the committee seems to move sharply away from the conciliatory position recently taken by the American Bar Association and the American Institute of Accountants [see 6 JTAX 158]. Those who hoped the ABA-AIA progress would eliminate inter-professional tension and litigation will be mightily disappointed by the Kentucky stand.

Obviously the ABA-AIA conciliation has not laid to rest the evil spectre which has for years plagued responsible tax practitioners in both professions. It is difficult to guess how widespread may be sympathy with the Kentucky position. Certainly a great deal of the Kentucky opinion would be taken exception to by those who have worked most with the question — lawyers and accountants alike.

The background

In an introductory note to the opinion, Henry H. Harned, Secretary of the Kentucky State Bar Association, points out that the rules of the Kentucky Court of Appeals permits questions of this kind to be submitted in this manner without litigation as required in many other jurisdictions. The Bar Association is asking, therefore, that the Court of Appeals uphold the Committee's opinion. Mr. Harned said:

"The Committee on Unauthorized Practice of Law and the Board of Bar Commissioners of the Kentucky State Bar Association are aware of the rules and regulations of various governmental agencies which authorize tax practice, the statement of principles entered into between the ABA and AIA, and the recommendations of their special committees that controversies between the two organizations be negotiated instead of litigated.

"While, under Kentucky Law, no compromise can be entered into that would permit the violation of the court's rules, the following opinion has been prepared in compliance with the above recommendation in order that the court may first determine a clear cut, fundamental question—whether the preparation and filing of a tax return is the practice of law. Once this is determined, the problems of jurisdiction, compliance, and enforcement will largely disappear and most of the confusion and uncertainty attending the question will be eliminated. Fortunately the rules of the Court of Appeals of Kentucky permit questions of this kind to be submitted in this manner without litigation as required in many other jurisdictions.

"All local bar associations or individuals wishing to offer an expression on the subject should file them with the secretary of the Kentucky State Bar Association by May 1, 1957."

Because this is the first outcropping of this kind in some many months, the exact language of the Advisory Opinion is probably required reading for those affected. We quote it in full here.

The committee's opinion

"The McCracken County Bar Association is seeking the facilities of the Committee on the Unauthorized Practice of Law to determine whether the preparation and filing of income tax returns constitutes the practice of law.

"It is the considered opinion of this Committee that it is.

"The fact that the Federal government has set up certain Tax Boards, Commissions, and Courts and authorized certain individuals to practice before them by issuing a card has nothing to do with the question before us except complicate it and make possible the unauthorized practice of law in varying degrees by unlicensed, unregulated, and unaccountable individuals. These cards are used to solicit business which may involve the giving of advice on laws of joint tenancy, gifts in contemplation of death, and many other matters of purely state law, including the preparation and filing of state as well as Federal tax returns.

"The Federal government has no authority to authorize any person to practice law regardless of the qualifications they may attain and it necessarily follows that any of its branches or subdivisions would be in a like position. This matter was decided by the Supreme Court of Florida in the Petition of Kearney, 63 So. 2d 630; by the Chicago Bar Association v. Kellogg, 88 N.E. 2d 519; and Agran v. Shapiro, 273 P. 2d 619. Although the power to license persons to practice law is one of the police powers reserved to the several state governments by the Tenth Amendment, a Tax Court will permit a Certified Public Accountant or other unauthorized person to file petitions and appeals in tax cases, interrogate and cross-examine witnesses, file motions, briefs, orders, and prosecute claims for refunds and otherwise conduct the trial of any tax matters before it.

"To engage in the practice of law has always been a privilege and not a right and from the earliest time the sovereign power has found it in the public interest to regulate the practice of law. The United States Supreme Court has frequently held that the power to license persons to practice law is one of the police powers of the state. Under the Tenth Amendment of the United States Constitution the powers not delegated to the United States are reserved to the states and the Constitution does not attempt to delegate any power to the Congress to license persons to practice law. Bradwell v. Illinois, 16 Wall 130; in re Summers 235 U.S. 561.

"There has been a determined effort in recent years by the lay practitioner to advance several propositions. One is that the preparation of a tax return is not the practice of law but the practice of accounting; or, that the preparation of the return may somewhat invade the legal field but that such slight invasion is the natural and necessary consequence of accounting work and that it is of

greater benefit to the public to permit the accountant to do the entire service than require the employment of both an accountant and a lawyer.

"It is not the purpose of this Committee to define the practice of Accountancy or the multiple services that may be performed by the financial advisor, the Notary Public, the Clerk, the estate planner, or the Tax Consultant. Many and varied are the valuable services that may be legally and ethically performed within their respective fields, but the minute a single act is done to a tax return the party so doing is practicing law. To fraudulently fill in any of the blanks or answer any of the questions constitutes a violation of the law; to fill them correctly constitutes a compliance with the law. The return is a legal document in its simplest form, and one that may be complicated by an accounting feature or the consequent gain or loss to the individual or his estate in no wise increases or diminishes its legal aspect. There can be no distinction between the simple and the complex. The unauthorized practice of law in any degree is a cancerous growth and unless it is swiftly and decisively stamped out the reputation of the legal profession can soon expect to disintegrate.

Taxes not separable from other law

"Another theory advanced by those engaging in the preparation of returns is the "Specialist" claim. They insist that their extensive and concentrated training in the tax field and their constant association with problems involving tax law better qualify them to handle tax matters than lawyers. In support of this claim they are now beginning to cite numerous instances of satisfactory tax practice by laymen and the recognition they are accorded in the tax courts, sometimes to the exclusion of the attorney, regardless of his qualifications unless he has also complied with certain rules and regulations. In addition they have available all the citations of unsatisfactory service performed in this field by some lawyers. However, tax law is not subject to mastery by concentration or study and experience in training in this field alone any more than a complete knowledge of the Criminal Code would enable an attorney to prosecute or defend a case of murder. It involves, and is intimately connected with, corporation law, partnership law, property law, the law of sales, trusts, and of descent and distribution, to name a few. The accountant is now making a determined effort to overcome this deficiency by studying law in connection with accounting. It is a required course in the CPA curriculum, and before an accountant can obtain a license as a CPA he must pass what is called the "legal" section of an examination which is comparable to a condensed version of a Bar Examination.

"Obviously, one trained only in tax law does not have the orientation even in this field to qualify as a tax lawyer. Likewise the obtention of a license to practice law does not automatically qualify all lawyers to engage in tax work and it is nowhere insisted that it does, but to permit the "expert" layman to engage in tax work, and carry on an unrestrained advertising campaign wherein exaggerated claims are made with respect to ability, the only result to be expected is the situation as we have it now. The incompetent, untrained, and unscrupulous self-styled expert jumping into tax work at an advantageous time of the year and then disappearing as soon as the season is over. The very nature of the preparation and filing of income tax returns is thus peculiarly susceptible to the most vicious form of the unauthorized practice of law and the public is the one to suffer. The courts of Kentucky have done all within their power to shield the public from such pitfalls and have charged every lawyer admitted before them with the duty to use this shield as a sacred trust. No man should be required to hire a lawyer if he does not wish to do so. But every man is entitled to receive legal advice from one learned and skilled in the law, qualified by character and reputation, sworn to promote and maintain the high standards of professional ethics, and subject at all times to the direct control and rigid discipline of the court.

"The unauthorized practice of law is an attempt on the part of laymen and corporations, through their erstwhile servants, agents, and employees, to make it a business for profit of giving the public as a substitute, the services of unqualified and unprofessional persons. The Bar of Kentucky never has, and the courts never will, permit the public to be imposed upon by any class of non-lawyers who, while claiming they are not practicing law, are in fact, doing so. Likewise there is no sound basis for a proposition to "come to terms" or "compromise" with any class or group seeking what amounts to a tolerance or actually a limited license to practice law by reason of some special ability or qualification, whether native or acquired. See RCA 3.020. In addition, so far as Kentucky is concerned, and so long as the aforementioned Rule remains in effect, there is no possibility of an "Agreement in Principles" between the Bar and any lay party, personal or corporate, if any portion of the activity sought to be engaged in constitutes the practice of law. See the Statement of Principles adopted by a Joint Conference of Lawyers and Accountants and approved by the American Institute of Accountants and the House of Delegates of the American Bar Association. 76 ABA Reports 699. All such propositions have as their ultimate purpose an aim to invade the realm of the practice of law. This does not harm the lawyers; he is well able to fend for himself. But to allow the penetration of any group, class, or calling that is untrained, unregulated, and undisciplined can only continue to add to the burden of the Bench and Bar in its vigilant efforts to protect the public. The years of constant and earnest effort on the part of our leading jurists and educators to raise as well as maintain the standards of the legal profession will have come to naught the moment any lay group that does not meet these standards is permitted to enter the field. The public will not only become confused and alarmed, it will be severely critical of the Bench and Bar for having permitted it to happen.

"The standards of education and the requirements as to character and fitness demanded by our courts as a prerequisite for admission to the practice of law, the control which the courts and the Bar Association have on the lawyers through its rules and the committees on ethics, the Canons which bind the lawyers to the highest fidelity to the interests of their clients and the public at large,

Canadian Tax Departments

IN OUR story on organization of the tax departments of Canadian companies [6 JTAX 256] we omitted to state that the survey had been made by the Canadian Tax Foundation, under the direction of its chief, J. Harvey Perry. We regret this omission, and desire now to draw attention to the source of this valuable information. *Editor.*

have all been evolved out of the need to protect the public from the unskilled, unqualified, and unethical advisors. Whenever any class or person who has not met the standards of character and education required for admission to the bar, who is uncontrolled by any code of moral or ethical principles in his relations with the public, who is not subject to the supervision or discipline of the court is permitted to practice law, even to a limited or incidental extent, the standards set for the protection of the public are impaired, the character and reputation of the Bench and Bar falls into disrepute, and the confidence and trust the public has a right to expect from the profession is destroyed.

"Finally, it is submitted that the preparation and filing of income tax returns is a service rendered involving legal knowledge and legal advice in respect to the lawful rights, duties, and the tax obligations and liabilities of the one requiring the services, and constitutes the practice of law."

NEW DECISIONS ON EXEMPT INSTITUTIONS

Foundation carried on speculative investment business; it's not exclusively charitable. The foundation was organized by one individual who contributed to it about $20,000 of marketable securities in which he had a substantial profit. He lent it about $150,000 which was since repaid. The first year it realized $40,000 profit, largely from speculative short-term trading in oil stocks. It donated $500 to charitable organizations. In its second year of activity, earnings were $58,000 and contributions $11,000. The district court denied exemption. This court affirms that the corporation was a business organization and its funds were used for business purposes. Exemption is not allowed a corporation because it ultimately intends to devote its profits to charity. *Randall Foundation, Inc.* CA-9, 1/18/57.

Washington procedures re prohibited transactions by exempt organizations. The Service denies exemption to an organization engaging in prohibited transactions. If the purpose is to divert corpus and if a substantial part of the organization assets is involved, exemption is automatically lost and no notice is required. In other cases the exemption is denied only after notice by the Commissioner. The IRS has established procedures as to the issuance by the National Office of registered notification letters and the granting of conferences. *Rev. Proc.* 57-5.

Organization to provide union members with transportation for medical care is exempt. An organization which furnishes transportation for medical care and services for the members of a designated labor union and their families qualifies for tax exemption as a voluntary employees' beneficiary association. No part of the net income can inure to the benefit of any private shareholder or individual, and 85% or more of its income must come from members and contributions by their employers. *Rev. Rul.* 57-61.

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